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In the Supreme Court of the United States

OCTOBER TERM, 1982

UNITED STATES OF AMERICA, PETITIONER

v.

ARTHUR YOUNG & COMPANY, ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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QUESTION PRESENTED

Whether tax accrual workpapers, prepared by a corporation's independent certified public accountant in the course of regular financial audits, are privileged from disclosure in response to an internal revenue summons issued under 26 U.S.C. 7602.

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ARTHUR YOUNG & COMPANY, ET AL.[1]

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

The Solicitor General, on behalf of the United States of America, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit in this case.

OPINIONS BELOW

The order of the district court (App. A, *infra*, 1a-15a) is reported at 496 F. Supp. 1152. The opinion of the court of appeals (App. B, *infra*, 16a-39a) is reported at 677 F.2d 211.

JURISDICTION

The judgment of the court of appeals was entered on April 13, 1982 (App. C, *infra*, 40a). The order denying the government's petition for rehearing was entered on June 22, 1982 (App. D, *infra*, 41a). By order dated September 13, 1982,

[1] Amerada Hess Corporation was also a party below, and is a respondent, along with Arthur Young & Co. For the sake of clarity, however, "respondent" refers only to Arthur Young & Co.

Justice Marshall extended the time within which the United States may file a petition for a writ of certiorari to and including October 20, 1982. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES INVOLVED

The pertinent provisions of Sections 7601, 7602 and 7604 of the Internal Revenue Code of 1954 (26 U.S.C.) are set forth in App. E, *infra*, 42a-43a.

STATEMENT

1. Respondent Arthur Young & Co., a firm of certified public accountants, has served as Amerada Hess Corporation's independent auditor since November 1971. In that capacity, respondent conducted financial audits of, and certified, Amerada's financial statements for 1972 through 1974 (App. B, *infra*, 19a). Federal securities laws require publicly-owned companies such as Amerada to file such certified financial statements annually. See 15 U.S.C. 78c and 17 C.F.R. Part 210 *et seq.* The certification process requires the independent auditor to evaluate the adequacy of the corporation's reserve for potential future tax liabilities. As part of its certification of Amerada's financial statements, respondent prepared tax accrual workpapers, which are documents and memoranda relating to respondent's evaluation of Amerada's tax liability reserves as they appeared in its financial statements. The tax accrual workpapers contain facts pertaining to Amerada's financial transactions based upon company records and respondent's interviews with company personnel and with third parties. The information in the tax accrual workpapers may identify specific items of questionable deductibility that Amerada claimed for the particular year. If the auditor determines that items are not deductible or could reasonably lead to additional tax liability upon examination by the Internal Revenue Service, it will recommend the establishment of additional contingency reserves (App. B, *infra*, 24a-25a).

In May 1975, the Internal Revenue Service began an audit to determine Amerada's corporate income tax liability for

1972 through 1974. Amerada is an integrated oil company incorporated in Delaware, and its reported gross revenues for the years under audit exceeded seven billion dollars. During the course of the audit, Amerada disclosed to the revenue agents that it had maintained a "special disbursement account," a fund from which political contributions, gifts to foreign government officials, and other illegal or questionable payments were disbursed, and that it had convened a special committee to investigate the company's practices with respect to such payments. Amerada turned over the final report of its special committee to the Internal Revenue Service. The report disclosed the deduction of some $7,830 in questionable payments during the years in question (App. A, *infra*, 2a-3a; App. B, *infra*, 19a). Upon receipt of this information, the Internal Revenue Service assigned Special Agent Kalemba of the Criminal Investigations Division to join the investigation. In furtherance of the joint investigation, the Special Agent issued an administrative summons, pursuant to 26 U.S.C. 7602, to respondent, seeking, *inter alia*, its tax accrual workpapers. Pursuant to 26 U.S.C. 7609, notice of the summons was sent to Amerada, which thereupon instructed respondent not to produce any of the documents called for by the summons (App. A, *infra*, 2a-3a; App. B, *infra*, 19a-20a).

On October 9, 1979, the government commenced this proceeding to enforce the summons in the United States District Court for the Southern District of New York. Pursuant to 26 U.S.C. 7609, Amerada intervened in the proceeding. Both Amerada and respondent filed answers to the petition opposing enforcement of the summons, objecting, *inter alia*, to the production of the tax accrual workpapers (App. A, *infra*, 3a; App. B, *infra*, 18a).

The district court enforced the summons and ordered production of the tax accrual workpapers. It found that the documents were relevant to the Internal Revenue Service's tax investigation of Amerada and rejected respondent's claim of an accountant-client privilege. The district court noted this Court had refused to recognize such a privilege in *Couch* v. *United States*, 409 U.S. 322, 335-336 (1973), and that the First Circuit adhered to that view, even where the client

claimed that it gave the information to the auditor under an expectation of privacy. See *United States* v. *Arthur Andersen & Co.*, 623 F.2d 725, 728 (1980). As the district court concluded, "While there may be an expectation of privacy insofar as the world at large is concerned, Amerada cannot reasonably have such an expectation [of privacy] with regard to the IRS which, the taxpayer knew, could call for all materials underlying the tax returns and payments" (App. A, *infra*, 9a).

2. A divided panel of the court of appeals reversed the district court's order with respect to the tax accrual workpapers (App. B, *infra*, 28a-32a).[2] The court agreed with the district court's finding that the tax accrual workpapers were relevant to the IRS audit of Amerada's tax liability (App. B, *infra*, 24a-27a). Despite the relevance of the material, the court refused to enforce the summons because of its belief that "these documents should remain confidential in order to protect the reliability of the independent audit process" (App. B, *infra*, 19a).

In support of its decision, the court of appeals expressed the view that the policies behind the disclosure requirements of the federal securities laws outweighed the policies in support of the Internal Revenue Service summons authority. As the court reasoned, these "countervailing policies" "require[d] * * * [it] to fashion protection for the work that independent auditors, retained by publicly owned companies to comply with the federal securities laws, put into prepara-

[2] The Internal Revenue Service's summons directed respondent to produce all files related to its client, Amerada Hess Corporation, for which respondent served as independent auditor (App. B, *infra*, 17a-18a, 20a n.4). The district court ordered the production of all items sought by the summons except respondent's audit program and the documents prepared by the special committee that investigated Amerada's questionable payments. The government did not appeal that portion of the district court's order, except with respect to the stated items. Accordingly, the only issues considered by the court of appeals were the production of audit workpapers and tax accrual workpapers (App. B, *infra*, 20a-21a). The court of appeals affirmed the district court's order with respect to the audit workpapers (App. B, *infra*, 21a-24a). They are accordingly no longer at issue (App. B, *infra*, 24a-32a). Hence, the only question before this Court involves the tax accrual workpapers.

tion of tax accrual workpapers" (App. B, *infra*, 28a). If the summons were enforceable, the court feared corporate management "might not be perfectly candid with independent auditors once it knew that the information revealed would be reachable under § 7602 (footnote omitted)" (App. A, *infra*, 30a). The court concluded that enforcement would therefore handicap investors, who must rely on independent auditors for financial information regarding publicly traded securities (App. B, *infra*, 31a).

In reaching its decision, the court drew support from the attorney's work-product doctrine of *Hickman* v. *Taylor*, 329 U.S. 495 (1947), and created an accountant's work-product privilege, requiring the Internal Revenue Service to make a heightened showing of need to justify production of such documents (App. B, *infra*, 31a). In the court's view, the Internal Revenue Service had not made the requisite showing because "[t]he corporation's own books and the audit workpapers furnish the IRS with all the raw data that it need[s] to calculate the taxpayer's tax liability" (App. B, *infra*, 31a).

The dissenting judge would have enforced the summons (App. B, *infra*, 33a-39a). He believed that Congress had legislated in favor of disclosure of all relevant documents not subject to traditional common law privileges, which do not include a privilege for either client communications to an accountant or an accountant's work-product. At all events, the dissent observed that "[i]f there is to be recognition of new privileges, we should leave that task to Congress" (App. B, *infra*, 35a). The dissent found nothing in the language or the legislative history of Section 7602 to indicate that Congress intended to exempt an accountant's work-product from Internal Revenue Service examination, or anything in *Hickman* v. *Taylor*, 329 U.S. 495 (1947), or the Federal Rules of Civil Procedure, that would permit a court to depart from the broad command of Section 7602 (App. B, *infra*, 36a-37a). As the dissent pointed out, there is no proper analogy between the attorney-client relationship and that of the public corporation and the independent public accountant. The attorney-client relationship is completely private and cloaked in confidence. On the other hand, an independ-

ent public accountant has public obligations to assure itself that contingent tax liabilities have been accurately reflected, and must decline to certify a statement if it is not satisfied that it is accurate (App. B, *infra*, 37a-38a).

The dissenting judge also rejected the majority's premise that corporations would be so anxious to minimize their tax payments that they would be willing to deceive their own accountants about debatable tax items and thereby violate their obligations under the securities laws. He doubted "that many corporations will be so anxious to avoid that result that they will conceal these debatable items from their accountants in violation of the securities laws" (App B, *infra*, 36a). But even on the assumption that the majority's speculation were accurate, the dissent concluded that the courts should not afford publicly held corporations "any shield behind which they can increase their chances of avoiding detection that they have not paid either the amount of taxes a court might rule was lawfully required or whatever adjustment might result from a post-audit settlement" (*ibid.*).

REASONS FOR GRANTING THE PETITION

1. In refusing to enforce an Internal Revenue Service summons directing a certified public accountant to produce tax accrual workpapers prepared in connection with its regular financial audits of a publicly held corporation and its certification of the corporation's financial statements, the decision below has created an accountant work-product privilege, under the rationale of an accountant-client privilege, that threatens to impede the Internal Revenue Service's tax investigations of public corporations. The case therefore stands in derogation of this Court's ruling in *Couch* v. *United States*, 409 U.S. 322, 335 (1973), that "no confidential accountant-client privilege exists under federal law, and no state-created privilege has been recognized in federal cases * * *."

Moreover, the decision conflicts with *United States* v. *El Paso Co.*, 682 F.2d 530 (5th Cir. 1982). There, the court enforced an Internal Revenue Service summons for the identical category of documents prepared by a public corporation's in-house accountants and revealed to its independent accountant as part of the process of establishing a reserve for contingent tax liabilities and certifying its financial statements. In so holding, the court relied upon this Court's ad-

monition in *Couch* that there is no federal accountant-client evidentiary privilege, and thereby rejected "[t]he logic of [the decision below that] implies that the taxpayer's revelation of tax accrual workpapers to an accountant should be considered a communication in confidence" (682 F.2d at 540–541).[3]

As the substantial *amici* participation in the court below by representatives of the accounting community demonstrates (App. B, *infra*, 16a-17a), the question presented is of major importance to the administration and enforcement of the revenue laws, and to the accounting and legal professions. The tax accrual workpapers at issue in this case record the auditor's determination of the adequacy of a public corporation's reserve for contingent tax liability under generally accepted accounting standards. Accordingly, they are concededly relevant to a legitimate tax investigation. While the Internal Revenue Service does not routinely seek these accountants' workpapers,[4] it does request them in the course of complex audits of large corporations with substantial tax liabilities. Hence, the question of the enforceability of summonses directing the production of such documents has already been the subject of appellate litigation[5] and is likely to recur with frequency. As matters now stand, these summonses are not enforceable in the Second Circuit, where the financial records of some of the nation's largest corporations are located. This Court should grant certiorari and establish a uniform national rule with respect to the production of such tax accrual workpapers.

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[3] We have been advised by counsel for El Paso Company that he intends to seek certiorari.

[4] See *Guidelines for Requesting Audit or Tax Accrual Workpapers*, [Audit] I Int. Rev. Man. (CCH) ¶ 4024.4 (May 14, 1981).

[5] See, *e.g.*, *United States* v. *Noall*, 587 F.2d 123 (2d Cir. 1978), cert. denied, 441 U.S. 923 (1979) (enforcing IRS summons to produce internal audit documents); *United States* v. *Arthur Andersen & Co.*, 474 F. Supp. 322 (D. Mass.), appeal dismissed, 612 F.2d 569 (1st Cir. 1979), cert. denied, 449 U.S. 1021 (1980) (enforcing IRS summons to produce audit work programs, tax accrual workpapers, and tax planning and consulting papers held by independent auditor); *cf. United States* v. *Coopers & Lybrand*, 550 F.2d 615 (10th Cir. 1977) (IRS summons for tax accrual papers not enforced on ground of lack of relevancy).

2. a. As the Court most recently reaffirmed in *Trammel* v. *United States*, 445 U.S. 40, 50 (1980), quoting *United States* v. *Bryan*, 339 U.S. 323, 331 (1950), any claim of privilege must overcome the settled principle that "'the public * * * has a right to every man's evidence.'" Accord: *Branzburg* v. *Hayes*, 408 U.S. 665, 688 (1972). "Whatever their origins, these exceptions to the demand for every man's evidence are not lightly created nor expansively construed, for they are in derogation of the search for truth." *United States* v. *Nixon*, 418 U.S. 683, 710 (1974). See also *Herbert* v. *Lando*, 441 U.S. 153, 175 (1979); *Blackmer* v. *United States*, 284 U.S. 421, 438 (1932); 8 J. Wigmore, *Evidence*, § 2192 (McNaughton rev. ed. 1961). Because testimonial privileges preclude the use of highly relevant evidence and therefore tend to be "an obstacle to the administration of justice" (*id.* § 2192, at 73; see *United States* v. *Nixon*, *supra*, 418 U.S. at 711-713), such privileges are tolerable only when they "are designed to protect weighty and legitimate competing interests" (*id.* at 709). See also *Elkins* v. *United States*, 364 U.S. 206, 234 (1960) (Frankfurter, J., dissenting).

b. These considerations are fully applicable to the summons authority of the Internal Revenue Service. Section 7602 of the 1954 Code, App. E, *infra*, 42a-43a, authorizes the Secretary "[t]o summon * * * any * * * person * * * to appear * * * and to produce such books, papers, records, or other data * * * as may be relevant or material" to ascertaining the correctness of any return. "The purpose of the statutes is not to accuse, but to inquire. Although such investigations unquestionably involve some invasion of privacy, they are essential to our self-reporting system, and the alternatives could well involve far less agreeable invasions of house, business, and records." *United States* v. *Bisceglia*, 420 U.S. 141, 146 (1975).

In determining the scope of this statutory obligation to "appear" and "give testimony to the Internal Revenue Service," this Court has frequently analogized the summons power to the common law duties attaching to the issuance of a testimonial summons. See *United States* v. *Bisceglia*,

supra, 420 U.S. at 147-148; *United States* v. *Powell*, 379 U.S. 48, 57 (1964). This common law duty has been expansively construed and limited principally by relevance and privilege. See, *e.g.*, *Blair* v. *United States*, 250 U.S. 273 (1919); *United States* v. *Bryan*, *supra*, 339 U.S. at 331. While the Court has recognized that there may be exemptions from the public duty to give evidence to a competent authority, the "primary assumption" was that a summoned party must "give what testimony one is capable of giving" absent an exemption "grounded in a substantial individual interest which has been found, through centuries of experience, to outweigh the public interest in the search for truth" (*ibid.*).

Moreover, the Court has consistently construed the breadth of the summons authority that Congress intended to confer in Section 7602 as embracing all appropriate measures for enforcement. See, *e.g.*, *United States* v. *Powell*, *supra*; *Donaldson* v. *United States*, 400 U.S. 517 (1971); *United States* v. *Bisceglia*, *supra*; *United States* v. *Euge*, 444 U.S. 707 (1980). "There is thus a formidable line of precedent construing congressional intent to uphold the claimed enforcement authority of the Service if authority is necessary for the effective enforcement of the revenue laws and is not undercut by contrary legislative purposes (footnote omitted)" (*id.* at 715-716). Simply put, an Internal Revenue Service summons to produce evidence relevant to a legitimate investigation is enforceable unless an established privilege protects such evidence or there are "unambiguous directions from Congress" to the contrary. *United States* v. *Bisceglia*, *supra*, 420 U.S. at 150.

3. Here, both courts below found that the tax accrual papers sought from respondent were relevant to the Internal Revenue Service's investigation of Amerada (App. A, *infra*, 8a; App. B, *infra*, 26a-27a). Despite this finding, the court of appeals refused to order production of these documents prepared by respondent in connection with its determination of the adequacy of Amerada's reserve for contingent tax liabilities and its certification of Amerada's financial statements, as required by the securities laws. As the court saw the matter, "[t]he verification procedure envisioned by the [Securi-

ties] Act requires, in turn, that management feel free to cooperate with their auditors, and to disclose to them confidential information, such as the questionable positions taken on tax returns * * *" (App. B, *infra*, 29a). Hence, the court concluded that the countervailing policies at issue in the case "* * * required[d] [it] to fashion protection for the work that independent auditors, retained by publicly owned companies to comply with the federal securities laws, put into preparation of tax accrual workpapers" (*id.* at 28a). In support of its decision, the court relied upon the attorney work-product doctrine established by this Court's decision in *Hickman* v. *Taylor*, 329 U.S. 495 (1947).

But the work-product doctrine has no bearing upon the enforceability of the IRS summons for accountant's workpapers at issue in this case. In *Hickman* v. *Taylor*, *supra*, the Court recognized a qualified privilege against pretrial discovery for certain materials prepared by an attorney "acting for his client in anticipation of litigation" (329 U.S. at 508). See *United States* v. *Nobles*, 422 U.S. 225, 236-240 (1975); *Upjohn Co.* v. *United States*, 449 U.S. 383, 397-399 (1981). Here, in marked contrast, the papers in question were prepared by accountants in the course of a regular audit of financial statements—and not in connection with litigation no matter how remotely contemplated. These two factors effectively distinguish *Hickman* and render the work-product doctrine irrelevant. *United States* v. *El Paso Co.*, *supra*, 682 F.2d at 542–543.[6] The court below therefore erroneously extended the work-product doctrine beyond its settled and appropriate bounds.

4. While the decision below is couched in terms of the work-product privilege, it is plain that the court's underlying reasoning rests upon the creation of an accountant-client privilege. For in refusing to enforce the summons for the accrual workpapers, the court believed that it was fostering

[6] Accord: *Coastal States Gas Corp.* v. *Department of Energy*, 617 F.2d 854, 864 (D.C. Cir. 1980) ("[work-product doctrine] has uniformly been held to be limited to documents prepared in contemplation of litigation"); *Goosman* v. *A. Duie Pyle, Inc.*, 320 F.2d 45, 52 (4th Cir. 1963) (reports prepared in ordinary course of business under Interstate Commerce Commission regulations are not work-product).

candid communications between client and accountant for the benefit of the investing public and the enforcement of the securities laws. Such a rationale is the essence of a communications privilege. See *United States* v. *El Paso Co.*, *supra*, 682 F.2d at 541 n. 13.

There are, we submit, four fundamental errors inherent in the court's conclusion. First, there is no accountant-client privilege, and the courts have uniformly resisted creating one because of the significant differences between attorneys and certified public accountants. Second, the court's conclusion that such a privilege is necessary in order to encourage enforcement of the securities laws is based upon an unfounded speculation that public companies would otherwise deceive their independent accountants. Third, there is no conflict between the enforcement of the securities laws and the tax laws. And fourth, even on the assumption that there is such a conflict, it is for Congress, and not the court below, to resolve it.

a. As we have pointed out (*supra*, page 6), this Court, and every court that has considered the issue, has rejected the creation of an accountant-client privilege. *Couch* v. *United States*, *supra*, 409 U.S. at 335-336; *Falsone* v. *United States*, 205 F.2d 734 (5th Cir.), cert. denied, 346 U.S. 864 (1953); *Wm. T. Thompson Co.* v. *General Nutrition Corp.*, 671 F.2d 100, 103-104 (3d Cir. 1982); *United States* v. *Gurtner*, 474 F.2d 297, 299 (9th Cir. 1973); *United States* v. *Wainwright*, 413 F.2d 796, 803 (10th Cir. 1969); *United States* v. *Kovel*, 296 F.2d 918, 922 (2d Cir. 1961); *United States* v. *El Paso Co.*, *supra*, 682 F.2d at 540. Indeed, the reason the law recognizes an attorney-client privilege and not an accountant-client privilege rests upon the important practical differences between the function of an accountant and that of an attorney. The attorney is an advocate whose duties to his client include presenting the client's case in the most favorable light possible. As this Court noted in *Upjohn Co.* v. *United States*, *supra*, 449 U.S. at 390-391, "[t]he first step in the resolution of any legal problem is ascertaining the factual background and sifting through the facts with an eye to the legally relevant." Accordingly, unless a client's communications to his attorney are to be held

in strict confidence, the attorney may not be able to determine the correct facts, and, therefore not be able to represent his client's cause to the best of his ability.

An independent certified public accountant performs a very different function from that of an attorney. As the title states, he is independent of his client, and his responsibility is not only to the client whose books he is auditing but also to various governmental agencies regulating his client's industry, to his client's creditors and to investors in his client's securities. This multiplicity of loyalties, in contrast to the attorney's undivided loyalty to his client, exposes accountants to suits by agencies, creditors and investors on the theory that the accountant ignored his duty to them in favor of his loyalty to his client. In such suits, it is common for accountants to disclose their clients' confidential communications and their own work-product in order to demonstrate that they properly discharged their duties to all.[7] Indeed, it was precisely those differences between accountants and attorneys that this Court recognized in *Couch* in rejecting the claim of an accountant-client privilege as to a taxpayer's records turned over to an accountant. As the Court stated (409 U.S. at 335-336):

> [T]here can be little expectation of privacy where records are handed to an accountant, knowing that mandatory disclosure of much of the information therein is required in an income tax return. What information is not disclosed is largely in the accountant's discretion, not * * * [the taxpayer's]. Indeed, the accountant risks criminal prosecution if he willfully assists in the preparation of a false return. * * *. His own need for self-protection would often require the right to disclose the information given him. * * * Accordingly, * * * [taxpayer] cannot reasonably claim * * * an expectation of * * * privacy or confidentiality.

[7] See, *e.g.*, *Pegasus Fund, Inc.* v. *Laraneta*, 617 F.2d 1335 (9th Cir. 1980) (Arthur Young & Co. produced its work papers to show that it had no reason to know of fraud by its client); *Oleck* v. *Fischer*, 623 F.2d 791 (2d Cir. 1980) (Arthur Andersen & Co. testified regarding reserves for notes payable appearing in client's financial statement); *Herzfeld* v. *Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27 (2d Cir. 1976); *SEC* v. *Geotek*, 426 F. Supp. 715 (N.D. Cal. 1976), aff'd, 590 F.2d 785 (9th Cir. 1979).

Thus, an accountant's client obviously cannot have an expectation of confidentiality similar to that of an attorney's client. There is accordingly no justification for the creation of an accountant-client privilege by the decision below.

b. Moreover, even on the assumption of the court below (with which we disagree) that there is some privilege that attaches to the communications between a client and his accountant that is somewhat analogous to the attorney-client privilege, the rationale for such a privilege does not exist in this case. the principal contemporary justification for the attorney-client privilege is its presumed value in encouraging clients to make full disclosure to their attorneys. *Upjohn Co.* v. *United States*, *supra*, 449 U.S. at 389; 8 J. Wigmore, *supra*, §§ 2291 and 2306, at 590. If damaging information could more readily be obtained from an attorney following disclosure than from the client himself in the absence of disclosure, a client aware of that fact would be reluctant to confide in his lawyer. See, *e.g.*, *United States* v. *Louisville & N. R.R.*, 236 U.S. 318, 336 (1915). The result would be greater difficulty in obtaining fully informed legal advice. "Since the privilege has the effect of withholding relevant information from the factfinder, it applies only where necessary to achieve its purpose. Accordingly it protects only those disclosures—necessary to obtain legal advice—which might not have been made absent the privilege." *Fisher* v. *United States*, 425 U.S. 391, 403 (1976).

But the communications from Amerada to respondent in this case would undeniably have been made in the absence of any protection of an accountant-client privilege. As a publicly held corporation, Amerada was required to file accurate and complete financial statements, certified by its independent auditors, with the SEC, if it wished to continue to have its stock publicly traded. See 15 U.S.C. 78*l*; 17 C.F.R. 210.1-02(d). Thus, Amerada had an independent legal duty to make the disclosures to respondent wholly without reference to or encouragement by any privilege. As the dissenting judge pointed out, there is accordingly no justification for the majority's premise "that some corporations are so anxious to minimize their tax payments that they are willing to deceive their accountants concerning the existence of

debatable items and thereby violate their obligations under the securities laws" (App. B, *infra*, 36a; (footnotes omitted)). Indeed, the cost of financial deceit is high for it can cut the corporation off from the public capital markets and expose it to private causes of action. It is therefore the accountant's public duty to withhold certification of a false, incomplete or misleading statement, and it is the sanctions of the securities laws—not the existence of any privilege—that provide the corporation with the necessary incentive to be candid with its independent auditor (see App. B, *infra*, 37a-38a). See also *In re John Doe Corp.*, 675 F.2d 482, 488-489 (2d Cir. 1982).

c. The court of appeals further erred in assuming a conflict between the federal statutes regulating securities and those enforcing revenue collection. Section 7602 of the 1954 Code unequivocally authorizes agents of the Internal Revenue Service to summon and inspect records that may be relevant to their investigation. On the other hand, the securities regulations relate to nothing more than the duty of listed corporations to file annual audited statements, and the duty of auditors to examine the statements under generally accepted principles of public accounting. The statutes and regulations do not even hint at any duty by the accountants to keep their clients' communications confidential. It would therefore be incongruous to enjoin accountants to do so when their basic function is clearly to insure that the public is informed accurately.

As the Court made clear in *St. Regis Paper Co.* v. *United States*, 368 U.S. 208 (1961), only a conflict that appears in the statutes themselves, as a clear statement of congressional purpose, will prevent disclosure of information. In *St. Regis Paper Co.*, Section 9(a) of the Census Act, 13 U.S.C. (1958 ed.) 9(a), prevented the Census Bureau from disclosing census information except in the form of statistical reports. St. Regis Paper Co. asserted that this prohibition was, in effect, a pledge of confidentiality and protected the company from having to disclose the same information to the Federal Trade Commission. This Court disagreed, holding that the statute merely forbade dissemination of the information by the Census Bureau; it said nothing to curtail the normal in-

vestigatory powers of other government agencies. The Court refused to infer such a limitation: "Ours is the duty to avoid a construction that would suppress otherwise competent evidence unless the statute, strictly construed, requires such a result." 368 U.S. at 218. The Court further pointed out (*ibid.*) that "when Congress has intended that like reports not be subject to compulsory process it has said so." The present case follows *a fortiori* from *St. Regis Paper Co.* since the securities laws and regulations do not contain any requirements of confidentiality for accountants. There is accordingly no justification for creating a privilege for such relevant materials as a defense to an otherwise valid Internal Revenue Service summons issued pursuant to a legitimate investigation.

d. Finally, even assuming that the court below correctly identified a conflict between the policies underlying the securities laws and the provisions regarding tax enforcement, the resolution of such a conflict properly lies with Congress and not in the courts. This is particularly true where, as here, the securities laws provide no explicit defense to the Internal Revenue Service's summons and a literal reading of the revenue provision directs that the documents be produced. There is no justification for the implicit assumption by the decision below that the securities law has somehow repealed or cut back on the scope of the Internal Revenue Service's summons authority. "One canon of construction is that repeals by implication are disfavored." *Regional Rail Reorganization Act Cases*, 419 U.S. 102, 133 (1974). Since the IRS summons statutes and the securities laws are "'capable of co-existence, it is the duty of the courts, absent a clearly expressed congressional intention to the contrary, to regard each as effective.'" *Id.* at 133-134, quoting *Morton* v. *Mancari*, 417 U.S. 535, 551 (1974). As the Fifth Circuit put it in *El Paso Co.* in reaching the opposite conclusion from that of the court below (682 F.2d at 545): "In the absence of a more profound clash between congressional policies, we cannot cut back on the summons power that Congress has given to the Service. We do not feel free to reweave the fabric of national legislation in accord with our notions of how various statutory schemes mesh. Such policy choices belong to the Congress."

CONCLUSION

The petition for a writ of certiorari should be granted.

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OCTOBER 1982

APPENDIX A

UNITED STATES OF AMERICA, PETITIONER,

v.

ARTHUR YOUNG & COMPANY, RESPONDENT

AND

AMERADA HESS CORPORATION, INTERVENOR

No. M-18-304 (KT1).

United States District Court,
S. D. New York.

Aug. 26, 1980

OPINION

KEVIN THOMAS DUFFY, District Judge:

This matter comes before the court on an order to show cause why respondent, Arthur Young & Company [hereinafter referred to as "Young"], should not be compelled to obey an Internal Revenue Service [hereinafter referred to as "IRS"] summons directing it to testify and to produce for examination certain documents pertaining to the tax liabilities of intervenor Amerada Hess Corporation [hereinafter referred to as "Amerada"] for tax years 1972, 1973 and 1974. The summons was issued pursuant to Section 7602 of

the Internal Revenue Code, 26 U.S.C. § 7602,[1] et al requested the documents set out in the margin.[2] The underlying investigation was commenced in August 1977, after

[1] 26 U.S.C. § 7602 provides as follows:

Examination of books and witnesses

For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability, the Secretary or his delegate is authorized

(1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry;

(2) To summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the Secretary or his delegate may deem proper, to appear before the Secretary or his delegate at a time and place named in the summons and to produce such books, papers, records, or other data, and to give such testimony, under oath, as may be relevant or material to such inquiry; and

(3) To take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry.

[2] The following documents relating to Amerada Hess Corporation all for the years 1972 through 1974:

1. Engagement letter(s)
2. Management letter(s)
3. Representation letter(s)
4. History file(s)
5. Standard workpaper index(s)
6. Administrative file(s)
7. Workpaper review file(s)
8. Engagement planning file(s)
9. Confirmation control file(s)
10. Significant event file(s)
11. Audit program file(s)
12. Audit workpaper's file(s)
13. Tax pool analysis file(s)
14. File(s) prepared during the course of work performed for the "special committee", including agreed procedures, selection process reports, schedules and other workpapers
15. The name of the partner in charge, engagement partner and/or senior auditor who directed the audit of Amerada Hess Corporation
16. Any other information pertinent to the audit of Amerada Hess Corporation covering the years 1972, 1973, and 1974

Amerada made certain disclosures to the IRS concerning the deduction of some $7,830 in questionable payments during the years in question.

On January 12, 1978, two IRS summonses ["the New Jersey summonses"] were served on Amerada at its New Jersey offices. Amerada notified the IRS that it would not comply with these summonses, whereupon the IRS filed an enforcement petition on April 26, 1978, in the United States District Court for the District of New Jersey.

After an evidentiary hearing, the late Judge Barlow entered an order on January 22, 1979, granting the petition to enforce. *United States* v. *Amerada Hess Corp.*, No. 78-753 (D.N.J.1978) ("Hess I"). The Third Circuit affirmed, 619 F.2d 980 (1980). Although the documents sought, and now turned over, pursuant to the New Jersey summonses are not the same as those sought in the present action, some of the issues litigated and resolved there are germane to these proceedings, as will be discussed below.

The summons in question here was served on Young by Special Agent Kenneth Kalemba of the IRS on April 17, 1978. Notice of this summons was sent to the taxpayer Amerada by certified mail on April 18, 1978. On April 21, 1978, the taxpayer, utilizing the provisions of 26 U.S.C. § 7609(a), directed Young, its outside auditor, not to comply with the summons.

The instant enforcement petition was filed by the IRS in this court on October 15, 1979 under 26 U.S.C. §§ 7402(b) and 7604(a). Respondent Young opposes the summons in its own right, as a matter of its own policy judgments, and not only because it has been directed by its client Amerada not to comply. Young advances five arguments against compliance. Amerada has also intervened and advances arguments of its own against compliancy.

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17. All workpapers, reports, records, correspondence, reconciliations and information relative to the United States Corporate Income Tax Returns (Forms 1120) of Amerada Hess Corporation that were prepared by Arthur Young & Company or under the supervision of Arthur Young & Company for the calendar years 1972, 1973 and 1974

Young's Arguments

Young puts forth what it characterizes as basic policy arguments as to why it should not be ordered to comply with the IRS summons. The first of these arguments is that the summons requests virtually every piece of paper in Young's files concerning Amerada, totalling approximately a quarter of a million pages, and that such an overbroad, generic request violates the second of the four requirements of *United States* v. *Powell*, 379 U.S. 48, 57-58, 85 S.Ct. 248, 254-255, 13 L.Ed.2d 112 (1964). Under *Powell*, the four essential criteria for the judicial enforcement of an IRS summons are:

> that the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, that the information sought is not already within the Commissioner's possession, and that the administrative steps required by the Code have been followed
>
> . . . .
>
> 379 U.S. at 57-58, 85 S.Ct. at 255.

According to Young, a request such as the one at hand is so broad that it negates the court's oversight function and effectively makes the IRS summons self-enforcing, contrary to the intent of Congress as set out in 26 U.S.C. § 7604.

The IRS responds that it has, through the affidavits of its agents, made an initial showing that the four *Powell* requirements have been satisfied,[3] and that the burden is therefore on respondent to show that enforcement would be an abuse of the court's process. The IRS argues that this burden has not been met. It also argues that generic and extensive document requests have repeatedly been upheld by the courts.

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[3] The court has been furnished with affidavits covering each of the four *Powell* requirements, *supra*, for judicial enforcement of an IRS summons. The four grounds are covered respectively by the affidavits of (1) Special Agent Kenneth J. Kalemba, and the Supplemental Affidavit of Special Agent G. Robert Armstrong; (2) District Director Harry Reiter, of the IRS New York District; (3) Revenue Agent Anthony Caputo of the IRS Newark District; and (4) Kenneth J. Kalemba, *supra*.

The cases cited by the IRS support its position and Young's attempts to distinguish them are unconvincing. In *United States* v. *Acker*, 325 F.Supp. 857 (S.D.N.Y. 1971), Judge Frankel approved a similarly broad IRS summons and construed 26 U.S.C. § 7602 as authorizing IRS inspection of documents which "'might' throw light upon subjects under legitimate inquiry." 325 F.Supp. at 862. As Judge Frankel reasoned in *Acker*, the IRS agents cannot and need not establish "probable cause" to justify their document demands. What they must do, and have done in the case at hand, is to show that the documents are sought in pursuit of a legitimate purpose and may be relevant to that purpose. *See United States* v. *Powell*, *supra*, 379 U.S. at 57, 85 S.Ct. at 254.

The end result of respondent's argument about generic document demands would be that a reviewing court must test each individual piece of paper for relevance and this cannot be.[4]

> The materials demanded must be "sufficiently relevant to the investigation," *United States* v. *Harrington*, 388 F.2d 520, 523 (2d Cir. 1968), a standard to be applied to categories of documents, not to every single document within any category. So, for example, to look no further than the case just cited, it may be confidently supposed that not all of the books and records there required to be produced (by the third party, not the taxpayer himself) would prove "relevant or material" to the subject being explored. But it was enough even where the burden was upon the third party there involved that there was "in the particular circumstances an indication of a realistic expectation rather than an idle hope that something [might] be discovered."

[4] "If what appellant desires is to have the district judge examine the materials *in camera* so as to increase his understanding of their relevancy and materiality to the tax investigation, this would be a task which, in most cases, certainly including this one, would be so burdensome and probably so impossible of performance that Congress could not have meant to impose it upon busy district judges.

United States v. *Noall*, 587 F.2d 123, 127 (2d Cir. 1978).

United States v. *Acker*, 325 F.Supp. at 862.[5]

Young attempts to distinguish the other cases relied on by the IRS on the grounds that the broad document requests approved in those cases were limited to records of actual transactions between the taxpayer and the third party. In most of the cases, however, the third party was a bank and the requests were only for records of transactions between the taxpayer and the bank. *United States* v. *Coopers & Lybrand*, 413 F.Supp. 942 (D.Colo.1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977), is the one case that did not involve an independent auditor, and made a distinction between transactional and other kinds of records. That case, however, is of no support to Young's attack on the breadth of the summons, for it denied enforcement of the summons only as to the audit program and tax pool analysis file. These issues will be discussed below.

Young's first argument must fail in that the present summons cannot be resisted simply on the grounds that it is overbroad.

Young next argues that its tax accrual files should, as a matter of law and policy, be protected from disclosure to the IRS. Tax accrual files, or the tax pool analysis papers, are the auditor's evaluation of the adequacy of the taxpayer-client's provision for taxes on the client's financial statements. They contain projections, opinions and hypotheses of possible tax consequences based on factual data derived from the client's records. Young argues that disclosure of such files to the IRS would seriously undermine the ability of the client to deal candidly with its auditor. It also argues that since they consist primarily of opinion, such files are not relevant to determining the client's tax liabili-

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[5] In a footnote to the quoted passage from *Acker*, Judge Frankel acknowledges that the Second Circuit in *Harrington* stressed that judicial protection is even more appropriate when sweeping demands are directed not to the taxpayer, but to a third party, as is the case with the present summons. However, fears of oppressing or harassing Young are muted here, since the IRS has agreed to inspect all the subpoenaed documents on site in Young's New York City and Tulsa, Oklahoma offices, and to pay for the costs of any documents it wishes to reproduce.

ty. Finally, Young seeks to assert an indirect auditor-client privilege by arguing that the client enjoys an expectation of privacy for communications to its auditor.

Although case law on this precise question is spare and in apparent conflict, enough of a pattern has emerged to support the view that the tax accrual workpapers should be turned over.

In *United States* v. *Coopers & Lybrand*, 413 F.Supp. 942 (D.Colo.1975), the District Court held the IRS had failed to establish the relevance of the audit program (discussed below) and of the tax accrual files of Johns-Manville's outside auditor. Accordingly, the court refused to order and enforcement of the summons. The Tenth Circuit affirmed, 550 F.2d 615 (10th Cir. 1977), relying on the undisputed facts that the files in question were not used in connection with the preparation and filing of the taxpayer's returns and that the auditor had no responsibility for any of the client's tax matters. That is not quite the situation which obtains in the case at bar.

The opposite result was reached in *United States* v. *Arthur Anderson & Co.*, 474 F. Supp. 322 (D.Mass.) *dismissed without opinion*, 612 F.2d 569 (1st Cir. 1979) (Table), where the court was not persuaded by Andersen's accountant-client privilege argument or by its relevance argument. Rejecting the reasoning of *Coopers & Lybrand*, *supra*, the District Court in *Andersen* relied on the language of § 7602 to conclude that the audit program and the tax accrual papers were "both relevant and reachable," in that the statute's "expansive language invites, and has generally been accorded, a liberal construction." 474 F.Supp. at 329. The court specifically rejected the argument that the papers should be shielded from disclosure because they were not used in preparing the tax returns under investigation.

The respondent and intervenor in *Arthur Andersen*, *supra*, failed to obtain a stay of the enforcement order from the District Court, the First Circuit, or the Circuit Justice, and accordingly turned over the documents requested in the summons. Their appeal from that part of the order below was consequently dismissed as moot.

Any doubt as to which of these conflicting precedents should be followed in this instance is laid to rest by *United States* v. *Noall*, 587 F.2d 123 (2d Cir. 1978) *cert. denied*, 441 U.S. 923, 99 S.Ct. 2031, 60 L.Ed.2d 396 (1979). *Noall* is not directly in point because the IRS summons in that case sought internal audit documents, and not the records of an independent auditor. However, the force and reasoning of *Noall* lead all but inescapably to the conclusion that the result in this Circuit would not be changed by this difference. Indeed, even though the Court of Appeals specifically reserved comment on the exact question presented here, *see* 587 F.2d at 127 n.5, the court left no doubt that it rejected the Tenth Circuit's reasoning in *Coopers & Lybrand*, *supra*:

> In refusing to enforce the summons in regard to the tax pool analysis, both the district court and the court of appeals gave much weight to the fact that this was not used in preparing the company's income tax return, 413 F.Supp. at 950, 953-54, 550 F.2d at 620-21. To the extent that the decision was influenced by this factor, it is not authoritative in this circuit.

587 F.2d at 127 (footnotes omitted).

Furthermore, *Noall* has been applied by a court outside this Circuit to order the disclosure of an independent auditor's "bluebacks," or audit reports on the taxpayer's internal accounting systems which were prepared by an independent auditor. *See United States* v. *The Riley Company*, 79 C. 4211 (N.D.Ill., January 8, 1980).

The IRS has made by affidavit, the showing of relevance required by *Powell*, *supra*. *See* Reiter Affidavit, ¶ 10; *United States* v. *Noall*, *supra*, 587 F.2d at 126; *United States* v. *Arthur Andersen*, *supra*, 474 F.Supp. at 329-30. Respondent's arguments that the tax accrual files are irrelevant and that their disclosure would undermine the auditor's function, are neither convincing nor supported by the weight of authority. *See Noall*, *supra*, 587 F.2d at 126. Respondent's argument based upon a supposed analogy to Exemption 5 in the Freedom of Information Act (dealing with internal government memoranda) is so wide of the mark that it does not merit discussion.

Nor can respondent be heard to assert an auditor-client privilege. The Supreme Court has refused to recognize such a privilege, *Couch* v. *United States*, 409 U.S. 322, 93 S.Ct. 611, 34 L.Ed.2d 548 (1973) and the First Circuit has very recently adhered to that view even where, as is the case here, the client claims that the information was given to the auditor under an expectation of privacy. *United States* v. *Arthur Andersen*, 623 F.2d 725, at 728 (1st Cir. 1980) (affirming District Court's enforcement of that part of the summons pertaining to Andersen's testimony about the tax accrual papers). While there may be an expectation of privacy insofar as the world at large is concerned, Amerada cannot reasonably have such an expectation with regard to the IRS which, the taxpayer knew, could call for all materials underlying the tax returns and payments.

Accordingly, I hold that respondent Young must make available for inspection by the IRS the tax accrual workpapers for Amerada covering the years in question.

Young makes basically the same arguments concerning its audit program workpapers for Amerada. These papers are the statement of the independent auditor's plan and program for the conduct of the audit. They are the auditor's methodology, the guidelines as to which areas and which records of the client will and will not be examined. Young argues that the audit program is confidential information which, if revealed to the client, might permit it to circumvent the audit, thereby defeating its very purpose.

Respondent's position on the audit program is sound. By definition, those papers are clearly less relevant to Amerada's tax liability than the tax accrual papers which, even though they consist in part of projection and hypotheses, also deal with facts and figures that form the basis of Amerada's tax liability, which the IRS desires to verify. The audit program, in contrast, stands many steps removed from the question of the actual tax liability.

Not only is the relevance of the audit program weaker, but the reasons for not disclosing it are stronger. The Second Circuit noted this in *Noall*, *supra*, 587 F.2d at 126 n.3, referring to the District and Circuit Courts' opin-

ions in *Coopers & Lybrand*, *supra*. The audit papers may be convenient for the IRS as a guide in its research, but convenience is not the touchstone here. The audit papers do not contain relevant data from which the IRS can assess the correctness of Amerada's tax returns. Accordingly, I must agree with what is explicit in both *Coopers & Lybrands* opinions, *supra*, and with what seems implicit in *Noall*, *supra*, and deny enforcement of that part of the instant summons, namely items 11 and 12, which seek production of Young's audit program and workpapers.

Young next argues that the 29 binders known as the Special Report Workpapers fall within the scope of the work product doctrine and therefore are protected from disclosure under *Hickman* v. *Taylor*, 329 U.S. 495, 67 S.Ct. 385, 91 L.Ed. 451 (1947). Young claims that it prepared these papers under a retainer from Amerada to assist Amerada's outside counsel, Milbank Tweed, in conducting an investigation into whether the corporation had made any improper foreign payments or political contributions.

The dispositive question on this claim is whether the papers in question were prepared in anticipation of litigation. *In re Grand Jury Subpoena*, 599 F.2d 504 (2d Cir. 1979). Judge Barlow in *Hess I* was faced with an issue tangentially related to the instant question. There, the IRS sought the names of all persons interviewed by Young in connection with the compilation of those 29 binders. A claim of privilege was raised by the taxpayer and in sustaining that claim, Judge Barlow held that the binders had been accumulated in contemplation of litigation.

Young argues that the IRS is bound by Judge Barlow's determination that the Special Report was prepared to assist counsel in anticipation of litigation and therefore protected from disclosure.

The IRS argues that the work-product doctrine does not apply in a summons enforcement proceeding, since the IRS is not bound by the rules of evidence applicable in judicial proceedings, but rather has a broad mandate from Congress to verify taxpayers' returns. The IRS argues that its investigative powers are not limited by, *inter alia*, the work-product doctrine. The Service further argues that

even if the doctrine is held to be applicable, as some courts have found, that the privilege is not absolute but may be, and in this case has been, overcome by the IRS's showing that it has "substantial need" for the materials in question and that the information cannot be obtained from any other source without undue hardship.

I agree with Judge Barlow's reasoning in *Hess I*, *supra*, that a party should not be completely barred from asserting the work-product privilege in the context of an IRS summons, but that in light of the unique inquisitorial mandate of the IRS, its burden of demonstrating "substantial need" to overcome the privilege should be reduced.

In passing upon the elements of the asserted privilege, I start from Judge Barlow's determination that the Special Committee was formed in anticipation of litigation.

I agree with respondent Young that the IRS has not met even a lowered burden of demonstrating both a substantial need for the Special Committee workpapers, and that the information contained therein cannot be obtained elsewhere without undue hardship. The IRS seems to rest on conclusory assertions of both need and hardship and can buttress its claims only with the statement that it has had to seek judicial enforcement of every subpoena it has addressed to Amerada or to any of its third party record keepers. Merely to say that a taxpayer has asserted its rights is no showing of "undue hardship" on IRS. As a citizen, I am somewhat appalled at the attitude which would produce such an argument.

The IRS may have a lower burden to overcome a claim of work-product privilege, but it still has some burden. The Reiter affidavit, which attempts to state the relevance of the subpoenaed documents of the IRS investigation, makes specific reference to several of the itemized requests in the summons, but refers to the Special Committee papers, item number 14 only as follows:

> The remaining items, numbered 14 through 17, pertain to specific factors involved in the investigation. (Reiter Affidavit, ¶3).

Furthermore, Young claims (Oresman Affidavit, ¶¶ 54–55) that the IRS has been furnished with the factual

data relating to the alleged questionable payments which were the focus of the Special Committee investigation. Also, the names of the persons interviewed by the Committee have been ordered turned over in *Hess I*, *supra*. These submissions indicate how far the IRS is from overcoming the asserted work-product privilege. Accordingly, I find that the 29 binders prepared by Young for Milbank Tweed's investigation need not be turned over to the IRS.

Young's final argument is moot, in that the IRS has agreed to inspect all documents on site in either Tulsa, Oklahoma, or New York City, and has further agreed to bear the costs of reproducing any documents it wishes to retain.

Amerada's Arguments

Intervenor-taxpayer Amerada has also advanced several arguments of its own against compliance. On one of these arguments, nothing more need be said since I have already held that the Special Committee Workpapers need not be turned over.

Amerada also argues that Young's tax accrual file should not be turned over. The only new argument it advances on this point is that such files do not consist of "books, papers, records, or other data" under 26 U.S.C. § 7602. By Amerada's own admission, no precise definition of such documents is provided by either the Internal Revenue Code or the legislative history of § 7602. Amerada's suggested statutory construction of that section amounts to no more than the argument that Congress must have intended such documents to be limited to records of actual transactions, and exclusive of judgmental or evaluative material. This argument has already been addressed, *supra*. The IRS has a wide latitude in fulfilling its mandate to police our basically self-reporting tax system, and a restrictive interpretation of the type of documents reachable under § 7602 would inhibit or defeat this mission. *See, e.g.*, *United States* v. *Bisceglia*, 420 U.S. 141, 145-46, 95 S.Ct. 915, 43 L.Ed.2d 88.

Amerada's final argument[6] is also without merit. It argues that the IRS has waived its right to seek enforcement by not insisting that Young appear on the return date of the summons, and because it did not institute this enforcement proceeding for several months after issuance of the summons.

There was no waiver by the IRS by reason of the lapse of time between issuance and institution of these proceedings. During this time, the Service was prosecuting other enforcement proceedings against Amerada and otherwise continuing the investigation.

Amerada, however, cites two cases in which the IRS was deemed to have waived enforcement by virtue of an agreement that respondent need not appear on the designated day. In *United States* v. *Malnik*, 489 F.2d 682 (5th Cir.), *cert. denied*, 419 U.S. 826, 95 S.Ct. 44, 42 L.Ed.2d 50 (1974), the IRS and the taxpayer's attorney agreed that instead of appearing to assert his Fifth Amendment privilege, the taxpayer would submit a written statement to the effect that, had he appeared, he would have asserted his appropriate constitutional privileges. The Fifth Circuit held that Malnik should have been required to appear and assert sert his constitutional claims to specific questions. However, the court went on to hold that the IRS had waived its right to seek enforcement because of its "indiscriminate agreement that Malnik need not comply with the demand of the summons" 489 F.2d at 688.

In *United States* v. *Lipshy*, 79-2 U.S.T.C. 88,274 (N.D. Texas 1979), the District Court found a similar waiver by the IRS, relying on *Malnik*, *supra*. The court found that even though the IRS did not evidence any subjective intention of abandoning enforcement of the summons, its agreement to dispense with the essential step in the examination process, i.e., the meeting at a time and place certain, acted as a waiver. The court refused to accept the Service's

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[6] By letter dated January 23, 1980, counsel for Amerada has withdrawn the defense that the summons was not issued in good faith, in light of the Third Circuit's affirmation of Judge Barlow in *Hess I*, 619 F.2d 980 (1980).

characterization of this agreement as merely a courtesy to avoid the necessity of the respondent's making a lengthy trip merely to announce that he would not comply.

These cases do not carry the day for Amerada for several reasons. *Malnik* involved the assertion of the Fifth Amendment privilege which, as the Fifth Circuit pointed out, could not be asserted in a blanket statement but must be raised only to specific questions and demands which would then be subject to court review. No such issue is involved here.[7] Second, in the present case, the only evidence offered of any "agreement" by the IRS is contained in ¶ 11 of the Affidavit of Carl D. Liggio, Arthur Young's General Counsel:

> 11. Following this conversation with Mr. Kalemba, I reiterated this in a telephone conversation on Thursday, April 20, 1978 and further confirmed it in a letter to him on April 25, 1978, a copy of which is attached as Exhibit A to this Affidavit. In that letter I stated:
>
> > As we further discussed when I met with you on April 17, I will be out of the area May 4, 1978, and thus unable to appear at the return date as established. *You indicated that because of our position with respect to the production, there was no need to appear and that the date was selected only to start the statutory period running.* (emphasis added).

The italicized portion could be read as an acceptance of an adjournment as much as an agreement to dispense with a meeting. In any event, it does not amount to an explicit "agreement" between the taxpayer and the IRS comparable to those in the cited cases.

Additionally, the IRS has changed its position on the "time and place certain" of the Amerada summons, and has agreed to examine the documents on site, as Amerada requested. Furthermore, in both *Malnik* and *Lipshy*, the IRS agreed to accept, in lieu of appearance, a written statement of respondent's objections. In the present case,

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[7] Because the Circuit Court in Malnik affirmed the District Court's refusal to enforce the summons, but did so on a wholly different ground, the IRS was not precluded from issuing another subpoena pertaining to the same material. 489 F.2d at 688 n.6.

no such agreement was reached. Indeed, Amerada instructed Young on April 21, 1978, not to comply with the summons, which was returnable on May 4. *See* Exhibit C to Enforcement Petition. No further formalism was required. The IRS, having no enforcement powers of its own, could hardly insist on compliance.

For all these reasons I find no waiver in the actions of the IRS following its issuance of the summons.

Accordingly, respondent Young is hereby directed to comply with the IRS summons of April 17, 1978 directing it to make available the requested documents pertaining to Amerada Hess, with the exception of the audit program (items 11 and 12), which is not relevant, and the Special Committee Report (item 14) which is protected under the work-product doctrine. All other items are to be made available for inspection by agents of the IRS at the Tulsa, Oklahoma or New York City offices of respondent. The IRS is to bear its own costs of reproducing whatever documents it deems necessary to copy.

SO ORDERED.

APPENDIX B

UNITED STATES OF AMERICA, PETITIONER-APPELLEE,

v.

ARTHUR YOUNG & COMPANY, RESPONDENT-APPELLANT,

AND

AMERADA HESS CORPORATION,
INTERVENOR-RESPONDENT-APPELLANT.

Nos. 15, 16, Dockets 81-6048, 81-6056.

United States Court of Appeals,
Second Circuit.

Argued Oct. 26, 1981.

Decided April 13, 1982.

Before FEINBERG, Chief Judge and MANSFIELD and NEWMAN, Circuit Judges.

FIENBERG, Chief Judge:

This is an appeal from an order of the United States District Court for the Southern District of New York, Kevin T. Duffy, J., enforcing an Internal Revenue Service (IRS) summons to Arthur Young & Co. (AY). The summons, issued pursuant to 26 U.S.C. § 7602,[1] directed AY to

[1] 26 U.S.C. § 7602 provides in relevant part that:

For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability, the Secretary or his delegate is authorized—

(1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry;

(2) To summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the Secretary or his delegate may deem proper, to appear before the Secretary or his delegate at a time and place named in the summons and to produce such books, papers, records, or other data,

produce all files related to its client, Amerada Hess Corp. (Amerada), for whom AY served as independent auditor. In response to an enforcement proceeding initiated by the IRS, Judge Duffy, in a decision reported at 496 F.Supp. 1152 (S.D.N.Y.1980), ordered the production of all the items requested by the IRS with two exceptions discussed below. The parties consented to a stay of production pending resolution of this appeal. In this court, AY challenges the district court's order, objecting primarily to the request for its audit workpapers file and for its tax pool (tax accrual workpapers) file. Amerada, utilizing the procedure available under 26 U.S.C. § 7609,[2] has intervened to challenge production of the tax accrual workpapers file. Because we

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and to give such testimony, under oath, as may be relevant or material to such inquiry: . . .

[2] 26 U.S.C. § 7609 provides in relevant part that:

(a) Notice—

(1) In general.—If—

(A) any summons described in subsection (c) is served on any person who is a third-party recordkeper, and

(B) the summons requires the production of any portion of records made or kept of the business transactions or affairs of any person (other than the person summoned) who is identified in the description of the records contained in the summons,

then notice of the summons shall be given to any person so identified within 3 days of the day on which such service is made . . . .

. . . .

(b) Right to intervene; right to stay compliance.—

(1) Intervention.—Notwithstanding any other law or rule of law, any person who is entitled to notice of a summons under subsection (a) shall have the right to intervene in any proceeding with respect to the enforcement of such summons under section 7604.

(2) Right to stay compliance.—Notwithstanding any other law or rule of law, any person who is entitled to notice of a summons under subsection (a) shall have the right to stay compliance with the summons if, not later than the 14th day after the day such notice is given in the manner provided in subsection (a)(2)—

(A) notice in writing is given to the person summoned not to comply with the summons, and

(B) a copy of such notice not to comply with the summons is mailed by registered or certified mail to such person and to such office as the Secretary may direct in the notice referred to in subsection (a)(1).

(c) Summons to which section applies.—

(1) In general.—Except as provided in paragraph (2), a summons is described in this subsection if it is issued under paragraph (2) of section 7602; . . .

find that the audit workpapers are relevant to determining Amerada's tax liability and thus fall within the scope of the IRS summons power, we affirm that part of Judge Duffy's order requiring their production. However, we reverse that part of the district court order enforcing the summons of the tax accrual workpapers. Although we find that this material is also relevant to the determination of tax liability, we believe that these documents should remain confidential in order to protect the reliability of the independent audit process.

I.

The involvement of Arthur Young & Co., a firm of certified public accountants, with Amerada Hess Corp. began in November 1971, when AY was retained as Amerada's independent auditor. Among its other duties, AY was responsible for reviewing the financial statements prepared by Amerada in satisfaction of the disclosure requirements of the federal securities law.[3] An AY partner also signed Amerada's tax returns, even though AY did not prepare the returns.

In April 1976, AY became further enmeshed in Amerada's affairs. Around that time, it became known that many American companies had made illegal payments abroad. In response to this publicity, Amerada's board of directors formed a special committee to investigate the possibility of Amerada wrongdoing. The law firm of Milbank, Tweed, Hadley & McCloy, and AY were engaged as independent investigators to assist the committee. This inquiry apparently, and despite the minor nature of the improprieties it uncovered, prompted the IRS in August 1977 to institute a criminal investigation of Amerada's tax returns for the years 1972, 1973, and 1974. Because a regular audit was then in progress, the IRS and Amerada designed a procedure in September 1977 to apprise the corporation of the progress of the criminal investigation. According to their agreement, Special Agent Kenneth Kalemba, who was in

[3] See § 12 of the Securities Exchange Act of 1934, 15 U.S.C. § 781, and Regulation S-X, 17 C.F.R. §§ 210 et seq. (1980).

charge of the criminal investigation, would issue all summonses relating to that inquiry. In April 1978, a summons signed by Kalemba was issued to AY, requiring it to make all its Amerada files available to the IRS.[4] A quarter of a million pages of documents are involved in this request.

The IRS sought to enforce this summons by an order to show cause, dated October 9, 1979. Judge Duffy tested the summons against the four criteria set forth in *United States* v. *Powell*, 379 U.S. 48, 57-58, 85 S.Ct. 248, 254-255, 13 L.Ed.2d 112 (1964):

> [The Commissioner] must show that the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, that the information sought is not already within the Com-

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[4] The summons requested the following documents relating to Amerada's tax liability for the years 1972–74:

1. Engagement letter(s)
2. Management letter(s)
3. Representation letter(s)
4. History file(s)
5. Standard workpaper index(s)
6. Administrative file(s)
7. Workpaper review file(s)
8. Engagement planning file(s)
9. Confirmation control file(s)
10. Significant events file(s)
11. Audit program file(s)
13. Audit workpaper's file(s)
13. Tax pool analysis file(s)
14. File(s) prepared during the course of work performed for the "special committee", including agreed procedures, selection process, reports, schedules and other workpapers.
15. The name of the partner in charge, engagement partner and/or senior auditor who directed the Amerada ...
16. Any other information pertinent to the audit of Amerada ... covering the years 1972, 1973 and 1974.
17. All workpapers, reports, records, correspondence, reconciliations and information relative to the United States Corporate Income Tax Returns (Forms 1120) of Amerada ... that were prepared by [AY] or under the supervision of [AY] for the calendar years 1972, 1973 and 1974.

At about the same time, a summons was issued to Amerada directly. Enforcement of this summons was also litigated, see *United States* v. *Amerada Hess Corp.*, 619 F.2d 980 (3d Cir. 1980), but none of the parties here contends that the different issues resolved there control the disposition of this appeal.

> missioner's possession, and that the administrative steps required by the Code have been followed. . . .

He found that with the exception of two types of documents, the summons satisfied all the prongs of the *Powell* test and, accordingly, enforced it. The exceptions related to AY's audit program and to the documents prepared by the special committee that investigated Amerada's questionable payments. Judge Duffy held that the audit program was irrelevant because it "stands many steps removed from the question of the actual tax liability." *United States* v. *Arthur Young & Co.*, 496 F.Supp. at 1157. He found that the committee report was protected by the work-product privilege under the doctrine of *Hickman* v. *Taylor*, 329 U.S. 495, 67 S.Ct. 385, 91 L.Ed.451 (1947), since the material was prepared under the auspices of Milbank, Tweed in anticipation of litigation, id. at 1157–58. The IRS does not appeal this portion of the district court's order. Among the documents that Judge Duffy did order turned over are AY's audit workpapers and tax accrual workpapers. The challenges advanced on appeal relate to these two categories.

II

AY alone objects to the production of its audit workpapers. These documents consist almost entirely of factual data generated from the books when accountants verify the financial statements prepared by Amerada's own personnel by spot-checking selected bookkeeping entries and records. They include third-party confirmations of transactions, as well as the auditor's own judgments about the implications of the company's transactions. Some of the workpapers contain material learned during confidential discussions between Amerada and AY employees. This material is not used in preparing Amerada's tax returns.

AY makes two objections to disclosure of these documents. First, it focuses on the second *Powell* criterion—relevance—and it claims that the IRS bears an enhanced burden of showing relevance when it seeks documents from a third-party, that is from an entity other than the taxpayer whose return it is auditing. Thus, AY at-

tempts to distinguished our holding in *United States* v. *Noall*, 587 F.2d 123 (2d Cir. 1978), cert. denied, 441 U.S. 923, 99 S.Ct. 2031, 60 L.Ed.2d 396 (1979), where a summons forcing a taxpayer to produce its own internal audit workpapers was enforced, on the ground that *Noall* did not involve a third-party. Where, as here, a stranger to the audit is involved, AY argues that this court's opinion in *United States* v. *Harrington*, 388 F.2d 520, 524 (2d Cir. 1968), controls and it is insufficient for the IRS merely to allege that some chance of relevance exists.

In *Harrington*, the target of the summons was a lawyer who had as his client the ex-wife of the taxpayer in whom the IRS was interested. In the course of enforcing the IRS summons, the court did point out that it was "particularly appropriate" that the lawyer and his client receive "judicial protection against ... sweeping or irrelevant order[s] ..." because the demand was "directed not to the taxpayer but to a third-party who may have had some dealing with the person under investigation." Id. at 523. But AY is not a stranger to Amerada's concerns in the same way that lawyer Harrington was to the husband taxpayer in *Harrington*. AY was hired to investigate Amerada's financial affairs, and to involve itself in matters that were likely to be the object of governmental inquiry. We do not believe that *Harrington* dictates the result sought by AY.

Moreover, we do not understand whose interests AY seeks to protect by this claim of an enhanced burden. Amerada does not need this protection: it can intervene in its own behalf under § 7609, see generally, Kenderine, The Internal Revenue Service Summons to Produce Documents: Powers, Procedures, and Taxpayer Defenses, 64 Minn.L.Rev. 73 (1979). And, in fact, it has done so. Since Amerada does not object to production of the audit workpapers, it would be anomalous to deny enforcement on the strength of its accountant's objection. Nor can AY assert any particular burden on it. Judge Duffy carefully protected AY from such possibilities by requiring the IRS to shoulder the costs and to inspect on site, *United States* v. *Arthur Young & Co.*, 496 F.Supp. at 1160.

Once it is accepted that the usual threshold of relevance applies, it is clear that the audit workpapers pass the *Powell* test. In *Noall*, we rejected a simplistic equation of relevance with use in tax return preparation, and recognized that

> the purposes of the internal audit include the detection of overstatements or understatements of revenues or expenses, and of identifying accounting procedures that would lead to these. If the internal auditors have ascertained an understatement of revenues or an overstatement of expenses, this plainly might throw light on the correctness of the returns.

587 F.2d at 126. AY has advanced no persuasive argument to distinguish between the usefulness of the internal audit procedure at issue in *Noall* and the external audit at issue here. The intervening decision in *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 99 S.Ct. 773, 58 L.Ed.2d 785 (1979), does not change this result. There the Supreme Court held that the accounting methods that a taxpayer uses for his own financial records cannot be dispositive of the accounting method used for tax purposes. But that does not mean that the reliability of the taxpayer's records is not legitimately of interest to the IRS. Tax liability depends on a taxpayer's actual revenue and expenses, not on his bookkeeping. The IRS has an appropriate interest in ensuring that the latter accurately reflects the former.

AY next maintains that the broad, generic document request issued here cannot be tolerated under the Fourth Amendment. The federal courts have repeatedly dealt with similar contentions, and have consistently rejected them. Before the IRS knows where the issues lie, it has no choice but to utilize a general summons. Similarly, before the Service knows what the documents contain, it cannot describe them with any specificity. If the target's own opinion of relevance controlled, the entire audit process would be eviscerated. The judges in this circuit have therefore construed the summons power liberally, and allowed it to extend to widely-sweeping document requests. See, e.g., *United States* v. *Noall*, 587 F.2d at 127 (rejecting even in camera review as being overly cumbersome); *Foster* v.

United States, 265 F.2d 183, 186-187 (2d Cir.), cert. denied, 360 U.S. 912, 79 S.Ct. 1297, 3 L.Ed.2d 1261 (1959); *United States* v. *Acker*, 325 F.Supp. 857, 862-63 (S.D.N.Y. 1971) (Frankel, J.). AY argues that cases such as these do not apply here because it is a third party, not the taxpayer, but we have already rejected that premise on these facts. We therefore affirm that portion of the district court's order requiring AY to turn over the audit workpapers.

III.

AY is joined by Amerada and a host of amici curiae in challenging the power of the IRS to compel the disclosure of tax accrual workpapers. These documents are generated when an auditor verifies whether the taxpayer has accurately determined its contingent tax liability. Under the federal securities laws, a registrant must file a financial statement of its potential liabilities. Furthermore, the amici tell us that generally accepted auditing standards require an auditor to determine whether his client has put aside enough reserves to cover the contingency that, upon audit, it will owe the government more taxes than originally remitted. To make this assessment, the auditor must not only determine how the taxpayer treated his income and expenses in his tax return; he must also decide whether that treatment comports favorably with the Internal Revenue Code, the Regulations, and the case law. In areas where the law is unclear, he must predict the chances that the taxpayer's position will be upheld by the courts—a judgment based on his knowledge of the law and his opinion of where the law is headed. The auditor must also take into account the likelihood that the client will settle the dispute—a judgment based on the auditor's confidential and intimate knowledge of the client. This process frequently requires the auditor to elicit and engage in speculation as to positions that might be taken by the IRS and taxpayer, theoretical analysis, and opinions bearing on the fairness and reasonableness of the parties' positions (as distinguished from factual transactional data), which, if revealed to the IRS, could seriously prejudice the taxpayer in negotiations with it. If the auditor were required to disclose this

material, which is not used in preparation of the taxpayer's return and is not needed by the IRS to determine the correctness of the taxpayer's return, the auditor would probably be inhibited from creating or maintaining such papers as part of a full and frank exchange useful in complying with the taxpayer's obligations under federal securities laws.

The Service's emerging practice of requesting tax accrual workpapers[5] has aroused considerable controversy in the accounting and legal professions,[6] as well as sharp disagreement among the courts that have considered the issue.[7] In this appeal, appellants advance three arguments for denying enforcement to this facet of the summons. First, Amerada vehemently claims that since the summons was signed by Special Agent Kalemba, the relevance of the tax accrual workpapers must be measured with respect to the criminal investigation that Kalemba was conducting. In order words, Amerada claims that the September 1977 agreement restricts the IRS's right to obtain material to the task of the agent who summoned it.

The short answer to this argument is that Amerada has failed to prove the nature of its agreement with the IRS. We cannot place limits on the broad mandate that § 7602

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[5] The Service changed § 4024 of its Internal Revenue Manual in June 1979 to insert guidelines for requesting these workpapers. In June 1980, this section was further strengthened, see Caplin, Should the Service Be Permitted to Reach Accountants' Tax Accrual Workpapers? 51 J.Tax. 194 (1979); Caplin, IRS Toughens its Stance on Summoning Accountant's Tax Accrual Workpapers, 53 J.Tax. 130 (1980); I.R.S. Eyes Accountants, 67 A.B.A.J. 1703 (1981). Amerada informs us, however, that in May 1981, the IRS issued new directives, backing down somewhat from its June 1980 position.

[6] In addition to the articles cited in note 5, supra, see, e.g., Kurtz, et al., Discussion on "Questionable Positions," 32 Tax Law, 13 (1978); Note, Government Access to Corporate Documents and Auditors' Workpapers: Shall we Include Auditors Among the Privileged Few? 2 J.Corp.L. 349 (1977).

[7] Compare *United States* v. *Arthur Andersen & Co.*, 474 F. Supp. 322 (D.Mass.1979), appeal dismissed as moot, 623 F.2d 720 (1st Cir. 1980), cert. denied, 449 U.S. 1021, 101 S.Ct. 588, 66 L.Ed.2d 483 (1980), with *United States* v. *Coopers & Lybrand*, 413 F.Supp. 942 (D.Colo.1975), aff'd, 550 F.2d 615 (10th Cir. 1977).

gives the IRS with no more than taxpayer's contested assertion that the Service agreed to that limit. A longer answer is that § 7602 is only a power to compel production for the purpose of determining civil liability. Had an iron-clad agreement been forged to restrict the summons to documents pertaining to the criminal investigation, the summons would probably not have been enforceable, see *United States* v. *LaSalle National Bank*, 437 U.S. 298, 98 S.Ct. 2357, 57 L.Ed.2d 221 (1978). But as that case points out, the agent's personal motivation would not be dispositive in any case. In deciding enforcement issues, the court's mandate is to look at the motive of the "Service in an institutional sense . . . ." Id. at 319, 98 S.Ct. at 2368. Besides, considerations of judicial economy compel us to decide this question on broader grounds: If we denied enforcement only because the documents were irrelevant to Agent Kalemba's purpose, the IRS could simply issue a new summons, and the case would come before us again. Cf. *Hickman* v. *Taylor*, 329 U.S. at 505, 67 S.Ct. at 390 (declining to insist on "the empty formality of pursuing the right procedural device only to reestablish precisely the same basic problem now confronting us.").

This brings us to a more fundamental inquiry, namely, whether the summoned documents are relevant to the civil audit. Appellants derive considerable support for the proposition that this material is irrelevant from the Tenth Circuit's decision in *Coopers & Lybrand*, supra, and from *United States* v. *Matras*, 487 F.2d 1271 (1973), where the Eighth Circuit refused to enforce a § 7602 summons for taxpayer's proposed budgets. The reasoning in both cases can be summed up as follows: Tax liability depends on the taxpayer's actual transactions, not on what the taxpayer thinks and plans. Tax accrual workpapers reflect what the taxpayer—and his accountant—think about transactions that have already taken place; budgets reveal how the taxpayer hopes to conduct his affairs in the future. They are thus both irrelevant to the question of actual transactions, and therefore to the issue of liability for taxes. These courts conceded that both sorts of documents would be convenient to the IRS because they give the Service a "road

map" for following the management of the taxpayer's business. They went on to hold, however, that "[t]he term 'relevant' connotes and encompasses more than 'convenience.'" Id. at 1275. Consequently, they refused to require that the documents requested be turned over to the government.

We cannot agree with such a restrictive definition of relevance. The summons power has consistently been interpreted as a broad mandate, designed to give the Service the "authority ... necessary for the effective enforcement of the revenue laws ...." *United States* v. *Euge*, 444 U.S. 707, 715–16 & n.9, 100 S.Ct. 874, 880 & n.9, 63 L.Ed.2d 141 (1980) (enforcing a summons for an examplar of taxpayer's handwriting). See also *United States* v. *Powell*, supra (refusing to require a showing of probable cause in an enforcement proceeding); *Donaldson* v. *United States*, 400 U.S. 517, 91 S.Ct. 534, 27 L.Ed.2d 580 (1971) (refusing to deny enforcement of civil summons even though potential for criminal prosecution exists); *United States* v. *Bisceglia*, 420 U.S. 141, 95 S.Ct. 915, 43 L.Ed.2d 88 (1975) (upholding IRS power to issue a John Doe summons). Consequently, we have consistently used as our test of relevance whether the documents requested "might have thrown light upon" the correctness of a return, see, e.g., *United States* v. *Shlom*, 420 F.2d 263, 265 (2d Cir. 1969), cert. denied, 397 U.S. 1074, 90 S.Ct. 1521, 25 L.Ed.2d 809 (1970); *Foster v. United States*, 265 F.2d at 187; *United States* v. *Noall*, 587 F.2d at 125; *United States* v. *Acker*, 325 F.Supp. at 862. The documents at issue here certainly pass this low threshold of relevance. Different tax positions lead to different amounts of liability. It is difficult to say that the assessment by the independent auditor of the correctness of positions taken by the taxpayer in his return would not throw "light upon" the correctness of the return.

Finally, the *Coopers & Lybrand* decision, upon which appellants have relied so heavily, emphasized the fact that the documents requested were not used in preparing the audited returns. This test has been rejected in this circuit, *Noall*, 587 F.2d at 126-27,[8] and accordingly, much of what was persuasive to the Tenth Circuit leaves us unimpressed.

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[8] It should be noted, however, that the decision in *Noall* specifically left open the issue now before us. 587 F.2d at 127 n.5.

The foregoing reasoning does not mean that the IRS summons in dispute here must now be mechanically enforced, for other considerations also bear on our decision. The Supreme Court has recognized that "contrary legislative purposes" can undercut the "broad latitude" otherwise provided to the IRS, *United States* v. *Euge*, 444 U.S. at 716 & n.9, 100 S.Ct. at 880 & n.9. It has also recognized that common law privileges serve to limit the scope of the IRS's power, *Upjohn* v. *United States*, 449 U.S. 383, 101 S.Ct. 677, 687, 66 L.Ed.2d 584 (1981); *United States* v. *Euge*, 444 U.S. at 714, 100 S.Ct. at 879. We think that the countervailing policies at issue in the case before us require us to fashion protection for the work that independent auditors, retained by publicly owned companies to comply with the federal securities laws, put into preparation of tax accrual workpapers.

Our starting point is *Hickman* v. *Taylor*, supra. In that case, the Supreme Court announced a policy of shielding "written statements, private memoranda and personal recollections prepared or formed by an adverse party's counsel in the course of his legal duties ..." 329 U.S. at 510, 67 S.Ct. at 393, not because the documents were "privileged or irrelevant," id. at 509, 67 S.Ct. at 392, but because their "[p]roper preparation ... is the historical and necessary way in which lawyers act within the framework of our system of jurisprudence to promote justice and to protect their clients' interests." Id. at 511; 67 S.Ct. at 393. *Hickman* was decided in the context of discovery under the Federal Rules of Civil Procedure, and the doctrine enunciated there has since been incorporated into Fed.R.Civ.P. 26(b)(3). But neither the Court nor Congress expressed an intent to limit the doctrine to the discovery context, *Upjohn Co.* v. *United States*, 101 S.Ct. at 689. Rather, we read both *Hickman* and Rule 26 as requiring us to balance strong public policies against a party's need for information whenever a conflict between the two arises.

The conflict in this case is between "the legitimate interest of society in enforcement of its laws and collection of the revenues," *Couch* v. *United States*, 409 U.S. 322, 336, 93 S.Ct. 611, 619, 34 L.Ed.2d 548 (1973), and the "national

public interest [in] insur[ing] the maintenance of fair and honest markets in [securities] transactions," 15 U.S.C. § 78b. Congress has protected the former interest by vesting the Service with "the extensive powers granted ... by the Internal Revenue Code," *United States* v. *Powell*, 379 U.S. at 56, 85 S.Ct. at 254, including the summons power of § 7602. The latter interest has been vindicated by extensively regulating the securities industry. Foremost among these regulations is the Securities Exchange Act of 1934, 15 U.S.C. § 78a et seq., which requires public companies such as Amerada Hess to file financial statements, 15 U.S.C. § 78l, verified by independent accountants "in accordance with generally accepted auditing standards," 17 C.F.R. § 210.1-02(d). The verification procedure envisioned by the Act requires, in turn, that management feel free to cooperate with their auditors, and to disclose to them confidential information, such as the questionable positions taken on tax returns, and willingness to settle rather than litigate when these positions are challenged by the IRS. The procedure recognizes that since tax laws must be general enough to treat complex and diverse factual situations, they are necessarily drafted with a great deal of flexibility. The Code's requirements are therefore not always clear, and people of good faith can often take different positions as to the correct answer in a particular circumstance. While it is quite possible that a corporation motivated to save its shareholders' money might take a favorable—i.e. "minimum tax"—position on a debatable item, it is equally true that the Service, which is also composed of mortals, might, in its zeal to maximize revenues, take an equally incorrect "maximum tax" position. We do not agree with the dissent's statement that in the end, the corporation "pay[s] only what the tax laws required it to pay in the first place." This would be true if every difference of opinion were litigated. But the fact is that very few controversies reach that stage. In reality, at the end of an audit, the IRS and the taxpayers frequently compromise out their differences, each giving in a little. Such negotiations strike an appropriate balance between collecting revenue and conserving

judicial resources, but requiring the taxpayer alone to disclose settlement positions would improperly weight the balance.

The result of working with a tax code that is not cast in black and white is that the independent auditor is faced with a very sensitive inquiry. In order to assess whether the corporation has set aside enough reserves to pay contingent liabilities, the auditor must pinpoint possibly vulnerable areas in his client's tax return and then predict how the corporation will handle the Service and vice versa, if these areas are questioned on audit. The inquiry necessarily lays bare not only the auditor's thoughts but also the taxpayer's basic thinking, including decisions not to litigate that are based on considerations wholly apart from the inherent legality of what the taxpayer ..as done, e.g., the cost of the litigation and the possibility that confidential information may be disclosed to competitors. Divulging this information necessarily puts the taxpayer-corporation at a substantial disadvantage when it is audited. The prejudice involved in exposing to the Service appraisals of a taxpayer's weaknesses and settlement positions on audit is of such proportions that a prudent organization might not be perfectly candid with independent auditors once it knew that the information revealed would be reachable under § 7602.[9]

The case at bar therefore involves much more than delineating the scope of the IRS's authority under § 7602. When the IRS chooses to regularly summon tax accrual workpapers, it creates a clash between two important congressional policies. No matter how we decide this issue, one

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[9] The government contends that taxpayer's independent duty to comply with the SEC laws is assured by the risk of SEC prosecution, and exposure to civil suit. The full answer to this contention is provided in *Upjohn Co.* v. *United States*, 101 S.Ct. at 684 n.2:

> This response ignores the fact that the depth and quality of any investigations ... would suffer .... The response also provides too much, since it applies to all communications covered by the privilege: an individual trying to comply with the law or faced with a legal problem also has strong incentive to disclose information to his lawyer, yet the common law has recognized the value of the privilege in further facilitating communications.

policy has to bend a bit. Giving the complete latitude to the summons power that the IRS seeks here compromises the procedure designed by Congress to protect the investing public from inaccurate financial information. Protecting the accuracy of the securities laws dilutes the power of the Service to summon a roadmap of the thoughts and theories of a taxpayer and its independent auditor. However, so long as a case does not involve allegations of fraud, the Service does not need to know taxpayer's thoughts. The corporation's own books and the audit workpapers furnish the IRS with all the raw data that it need to calculate the taxpayer's tax liability. A roadmap would merely save the IRS some time in finding the best arguments for asserting the deficiency. The investing public, on the other hand, relies most exclusively on the data generated as a result of the SEC laws. It therefore seems to us that this collision requires that some form of privilege be carved out to protect the independent auditing process. A work-product privilege, similar to the privilege fashioned in *Hickman*, seems to us appropriate. It protects those who benefit from enforcement of the securities laws from the "grave dangers of inaccuracy and untrustworthiness," *Hickman*, 329 U.S. at 513, 67 S.Ct. at 394, that would result if tax accrual workpapers were routinely revealed to the Service. At the same time, it allows the IRS to procure these documents when the rare situation[10] arises where it can make a sufficient showing of need to adequately justify invading the integrity of the auditing process, cf. *Hickman*, 329 U.S. at 512-13, 67 S.Ct. at 394, Fed.R.Civ.P. 26(b)(3). In reaching this conclusion, we are comforted by the knowledge that if Congress feels that this privilege unduly restricts the IRS's authority, it can require that this material be made available, or that taxpayers flag their questionable positions directly on their returns, in line with the suggestions of former Commissioner Kurtz, 32 Tax Law. at 15-16; Cooper, The Avoidance Dynamic: A Tale of Tax Planning, Tax Ethics,

[10] See, e.g., Caplin, 51 J.Tax at 199 (corporate records destroyed by fire).

and Tax Reform, 80 Colum.L.Rev. 1553, 1612 (1980). Procuring tax accrual workpapers under § 7602 seems to us to effectuate Commissioner Kurtz's proposals through the back door.

In the case at hand, the IRS has not made a sufficient showing of need to override the privilege. Presumably, Amerada has made its own books available pursuant to the Third Circuit's decision in *United States* v. *Amerada Hess Corp.*, supra. In addition, this decision directs AY to release its audit workpapers, along with the other papers that the district court required it to turn over. Since the IRS is not attempting to prove that Amerada is guilty of fraud, the documents released should be sufficient for its purpose of determining the accuracy of Amerada's returns.

For the foregoing reasons, the judgment of the district court is affirmed in part and reversed in part.

NEWMAN, Circuit Judge, concurring in part and dissenting in part:

The Court today creates a form of accountant's work-product privilege to shield from scrutiny by the Internal Revenue Service an accountant's tax accrual work papers. These papers, reflecting the accountant's identification of doubtful items on the income tax return of the accountant's corporate client, would be examined by the I.R.S. pursuant to its summons authority, 26 U.S.C. § 7602 (1976), but for today's judicially-created exception. I respectfully dissent from this aspect of the Court's decision,[1] believing that Congress has legislated in favor of such examination, that if Congress has left the question open, the decision to create an accountant's work-product privilege should be made by Congress and not by a court, and that if the merits of such a privilege are to be weighed by a court, we should reject it.

1. In enacting § 7602, Congress has given the I.R.S. a broad summons authority to seek all information "relevant to a legitimate investigative purpose," *United States* v. *Bisceglia*, 420 U.S. 141, 146, 95 S.Ct. 915, 918, 43 L.Ed.2d 88 (1975). The majority agrees that Arthur Young's tax accrual work papers are relevant to the legitimate investigative purpose of determining the correctness of the tax returns of its client, Amerada Hess Corporation. In the absence of a preexisting privilege, such as the privilege against self-incrimination or the attorney-client privilege, this determination that § 7602 applies should result in enforcement of the summons. The majority does not purport

[1] I concur in those portions of Chief Judge Feinberg's opinion upholding enforcement of the summons for Arthur Young's audit work papers and determining that its tax accrual work papers are relevant to the I.R.S.'s civil audit of Amerada Hess Corporation.

to find anything in the text of legislative history of § 7602 to support an exception for an accountant's tax accrual work papers. I do not find anything in *Hickman* v. *Taylor*, 329 U.S. 495, 67 S.Ct. 385, 91 L.Ed. 451 (1947), or Rule 26 of the Federal Rules of Civil Procedure that requires or even permits this Court to depart from the broad command of § 7602.

The Supreme Court has observed that § 7602 is subject to the "'traditional privileges and limitations,'" *Upjohn Co.* v. *United States*, 449 U.S. 383, 398, 101 S.Ct. 677, 686, 66 L.Ed.2d 584 (1981), quoting *United States* v. *Euge*, 444 U.S. 707, 714, 100 S.Ct. 874, 879, 63 L.Ed.2d 141 (1980), which do not include a privilege for either client communications to an accountant, *e.g.*, *United States* v. *Wainwright*, 413 F.2d 796, 803 (10th Cir. 1969), *cert. denied*, 396 U.S. 1009, 90 S.Ct. 566, 24 L.Ed.2d 501 (1970); *United States* v. *Bouman*, 358 F.2d 421, 423 (3d Cir. 1966), or an accountant's work product, *e.g.*, *United States* v. *Kelly*, 311 F.Supp. 1216, 1217 (E.D.Pa.1969); *In re Rashba & Pokart*, 271 F.Supp. 946, 948 (S.D.N.Y.1967).[2] In *United States* v. *Noall*, 587 F.2d 123 (2d Cir. 1978), *cert. denied*, 441 U.S. 923, 99 S.Ct. 2031, 60 L.Ed.2d 396 (1979), we were asked to create an exception for a corporation's own internal audit reports and related work papers on the ground that their disclosure to the I.R.S. would run counter to public policy by inhibiting frank disclosure from corporate employees to internal auditors. In rejecting that argument, we stated, "With respect to enforcement of tax laws, Congress itself has decided the policy issue, and it is

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[2] Federal law does not recognize accountant privileges even when the law of the forum state accords protection. *William T. Thompson Co.* v. *General Nutrition Corp.*, 671 F.2d 100 (3d Cir. 1982); *FDIC* v. *Mercantile National Bank of Chicago*, 84 F.R.D. 345, 349 (N.D.Ill.1979).

not for the courts to challenge that determination."[3] *Id.* at 126. I would accept Congress' judgment and enforce the summons fully.

2. If it were thought that the broad command of § 7602 leaves open the issue of whether to create an accountant's work-product privilege for tax accrual work papers, the decision to create such a privilege should be made by Congress. We have been authoritatively instructed not to place restrictions on the scope of § 7602 "absent unambiguous directions from Congress." *United States* v. *Bisceglia*, *supra*, 420 U.S. at 150, 95 S.Ct. at 920. I do not share the majority's comfort in knowing that if Congress prefers *not* to maintain an accountant's work-product privilege, it remains free to abolish it. That approach inverts the proper relationship between courts and Congress in this area. Congress has already legislated on the subject of the I.R.S.'s authority to examine relevant information, and it has thus far refrained from restricting the summons authority with any privileges unknown to the common law. If there is to be recognition of new privileges, we should leave that task to Congress. *Cf. City of Milwaukee* v. *Illinois*, 451 U.S. 304, 101 S.Ct. 1784, 68 L.Ed.2d 114 (1981) (presumption of preemption of federal courts' common law role as to subjects on which Congress has legislated). Especially is this the proper approach in matters concerning the tax laws, perhaps the one area of all national legislation in which Congress is most alert to remedy perceived inequities.[4]

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[3] I recognize that *Noall* explicitly left open the issue of whether § 7602 authorizes inspection of an accountant's tax accrual work papers, 587 F.2d at 127 n.5. However, several courts, including the District Court in this case, have found the rationale of *Noall* persuasive in upholding an I.R.S. summons for an accountant's tax accrual work papers. *United States* v. *Riley Co.*, 80-1 U.S. Tax Cas. (CCH) 9157 (N.D.Ill. Jan. 8, 1980); *United States* v. *Arthur Andersen & Co.*, 474 F. Supp. 322, 330 (D.Mass.1979), *appeal dismissed as moot*, 623 F.2d 720 (1st Cir.), *cert. denied*, 449 U.S. 1021, 101 S.Ct. 588, 66 L.Ed.2d 483 (1980); *cf. In re Grand Jury Subpoenas Duces Tecum Involving Charles Rice*, 483 F.Supp. 1085, 1088 (D.Minn.1979).

[4] Congress, which annually amends the tax laws, sometimes as to details concerning a single taxpayer, has had notice that federal courts are enforcing I.R.S. summonses for accountant's tax accrual work pa-

3. If we were to enter the policy debate as to whether to create a privilege to protect an accountant's tax accrual work papers, the privilege should be rejected. The majority suggests the privilege is needed to ensure that public corporations will be truthful with their accounts in fulfilling their statutory obligations to file financial statements verified by independent accountants. *See* 15 U.S.C. § 78*l* (1976); 17 C.F.R. § 210.1-02(d) (1981). Analogy is drawn to the work-product privilege of attorneys. I am not persuaded by either the argument or the analogy.

The policy argument rests on an indictment of corporate America that I do not accept. The premise is that some corporations are so anxious to minimize their tax payments that they are willing to deceive their accountants concerning the existence of debatable tax items and thereby violate their obligations under the securities laws.[5] Doubtless all corporations are anxious to pay only the minimum taxes required, and, toward that end, many will take favorable positions on debatable items, some of which the I.R.S. will successfully challenge. But even when the I.R.S. prevails, the corporation ends up paying only what the tax laws required it to pay in the first place.[6] I doubt that many corporations will be so anxious to avoid that result that they will conceal these debatable items from their accountants in violation of the securities laws. But if a few are so tempted, courts should not afford them any shield behind which they can increase their chances of avoiding detection that they have not paid either the amount of taxes a court might rule was lawfully required or whatever adjustment might result from a post-audit settlement. In *Noall* we declined to give

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pers, at least since 1979 when *United States* v. *Arthur Andersen & Co.*, *supra*, was decided.

[5] To the extent that the majority is creating a privilege to encourage communication from the client to the accountant, it is creating a testimonial privilege for the corporation, not a work-product protection for the work of the accountant.

[6] I assume the majority's privilege will protect an accountant's analysis of potential liability only of a civil nature. An accountant's privilege, no more than the attorney-client or attorney work-product privileges, should surely not insulate on-going attempts by the corporation or its accountants to carry out criminal evasion of taxes.

corporations an opportunity to shield their own audit work papers from I.R.S. scrutiny, despite the argument that employees would be tempted to deceive internal auditors. I see no reason to be more solicitous of corporations when they elect to enter public capital markets where they are obliged to accept the requirements of complete and honest financial disclosure.

Moreover, the argument that corporate taxpayers will be reluctant to assist in creating records accurately reflecting their contingent tax liabilities proves too much. If that premise were followed, we should insulate from § 7602 all the taxpayer's records supporting his claimed tax liabilities, since their inspection by the I.R.S. frequently results in an upward adjustment of tax payments and the taxpayer therefore has an incentive not to maintain them. It is entirely speculative whether the statutory disclosure obligations of the securities laws present a greater need to create new privileges than do the record maintenance obligations of the tax laws themselves. *See, e.g.*, 26 U.S.C. § 7203 (1976).

Arguably, it is more important to protect the investing public with contingent-tax-liability disclosure obligations than to protect the public revenues with tax-record maintenance obligations and undiminished summons authority, but that is precisely the sort of policy choice to be made by Congress. A legislative hearing is a better forum than this appeal to determine how realistic is the threat that occasional instances of understated contingent tax liabilities that result in additional tax payments will prejudice investor decisions and whether such a threat justifies diminution of tax revenues by preventing the I.R.S. from focusing its limited auditing resources on identified questionable items.

Furthermore, it is far from clear that the absence of an accountant's work-product privilege increases the risk that a corporation would have much success even if it were tempted to default on its disclosure obligations in the area of contingent tax liabilities. The corporation's independent public accountant has public obligations to assure himself that contingent tax liabilities have been accurately reflected. If the corporation blocks the efforts of the accountant to

ascertain the true state of the company's contingent tax liabilities, the accountant would be obliged to decline to certify the financial statements.

This last consideration indicates why the work-product privilege of the attorney is not analogous. The attorney is retained by the client in a completely private relationship, frequently to protect his client against claims of the Government. The work-product privilege assures legitimate privacy to the activity of the attorney in discharging his obligations to the client in vindication of a constitutional right to effective counsel. If the client elects not to make full disclosure to his attorney, the attorney may still undertake the defense; though he may not knowingly abet perjury, he has no obligation to the public to elicit and disclose the true state of his client's affairs. The certified public accountant, however, especially when he certifies financial statements of public corporations, has responsibilities to the public that far transcend his private employment relationship. In preparing and certifying such statements, he is not retained to defend his client against the Government; he is retained to assist his client in complying with government obligations to inform the investing public.

Finally, it is worth noting that privileges generally are created to serve some policy, independent of lawful obligations, that it thought to be impaired in the absence of the privilege. The law does not require spouses to confide in each other, but it nonetheless accords a marital privilege to promote family harmony. Similarly, the law does not require a client to confide in his attorney, but it nonetheless accords an attorney-client privilege to promote the effective assistance of counsel. The majority's privilege for accountants may be the first instance of a court creating a privilege to facilitate compliance with duties already imposed by law.[7]

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[7] The majority suggests that the Supreme Court in *Upjohn Co. v. United States*, *supra*, 449 U.S. at 393 n.2, 101 S.Ct at 684 n.2, has discounted the significance of a legal obligation of communication and disclosure in determining the scope or existence of a privilege. The footnote in *Upjohn* replied to the argument that the corporate client had an incentive to consult with its attorney and therefore did not need an

For all of these reasons,[8] I respectfully dissent from the judicial creation of an accountant's work-product privilege to insulate tax accrual work papers from the scope of § 7602.

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attorney-client privilege broader than the "control group" test. In declining to restrict an existing privilege because the client had an *incentive* to communicate, the Court had no occasion to assess whether a *legal obligation* to disclose conclusions (here, contingent liabilities) should be ignored in determining whether to create a new privilege to protect underlying details (here, questionable tax items).

[8] An additional reason advanced by the majority for favoring an accountant's work-product privilege is to prevent the I.R.S. from obtaining "backdoor" implementation of the suggestion of former I.R.S. Commissioner Jerome Kurtz that taxpayers should flag their questionable tax items. Kurtz, et al., *Discussion on "Questionable Positions,"* 32 Tax Law. 13, 15-16 (1978). Whether or not the I.R.S. can or should add such a sweeping self-questioning feature to the self-reporting tax system is fairly debatable. But once the I.R.S. has decided to devote its limited resources to an audit or investigation of a particular taxpayer, it should not be obstructed from concentrating its efforts on questionable items nor barred from identifying such items either by inquiry of the taxpayer and his accountant or, more profitably, by inspection of relevant documents.

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE
SECOND CIRCUIT

Nos. 81-6048, 81-6056

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the thirteenth day of April one thousand nine hundred and eighty-two.

Present:

HON. WILFRED FEINBERG, CH.J.

HON. WALTER R. MANSFIELD

HON. JON O. NEWMAN

UNITED STATES OF AMERICA, PETITIONER-APPELLEE,

v.

ARTHUR YOUNG & COMPANY, RESPONDENT-APPELLANT,
AND AMERADA HESS CORPORATION,
INTERVENOR-RESPONDENT-APPELLANT

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the judgment of said District Court be and it hereby is affirmed in part and reversed in part in accordance with the opinion of this court.

A. DANIEL FUSARO,
Clerk

By: ARTHUR HELLER,

Deputy Clerk

A TRUE COPY
A. DANIEL FUSARO, CLERK

By: FRANCIS X. GINDHART

Chief Deputy Clerk

Filed in U.S. District Court, S.D. N.Y. July 7, 1982

APPENDIX D

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

At a stated term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse, in the City of New York, on the 22nd day of June, one thousand nine hundred and eighty-two.

UNITED STATES OF AMERICA, PETITION-APPELLEE,

v.

ARTHUR YOUNG AND COMPANY, RESPONDENT-APPELLANT,

AND

AMERADA HESS CORPORATION,
INTERVENOR-RESPONDENT-APPELLANT.

NOS. 81-6048, 81-6056

FILED JUNE 22, 1982

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for the petitioner-appellee, United States of America,

Upon consideration by the panel that heard the appeal, it is

ORDERED that said petition for rehearing is DENIED.

It is further noted that the suggestion for rehearing in banc has been transmitted to the judges of the court in regular active service and to any other judge on the panel that heard the appeal and that no such judge has requested that a vote be taken thereon.

A. DANIEL FUSARO,
Clerk

By: FRANCIS X. GINDHART

Chief Deputy Clerk

APPENDIX E

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 7601. CANVASS OF DISTRICTS FOR TAXABLE PERSONS AND OBJECTS.

(a) *General Rule.*—The Secretary shall, to the extent he deems it practicable, cause officers or employees of the Treasury Department to proceed, from time to time, through each internal revenue district and inquire after and concerning all persons therein who may be liable to pay any internal revenue tax, and all persons owning or having the care and management of any objects with respect to which any tax is imposed.

SEC. 7602. EXAMINATION OF BOOKS AND WITNESSES.

For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability, the Secretary or his delegate is authorized—

(1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry;

(2) To summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the Secretary may deem proper, to appear before the Secretary or his delegate at a time and place named in the summons and to produce such books, papers, records, or other data, and to give such testimony, under oath, as may be relevant or material to such inquiry; and

(3) To take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry.

SEC. 7604. ENFORCEMENT OF SUMMONS.

(a) *Jurisdiction of District Court.*—If any person is summoned under the internal revenue laws to appear, to testify, or to produce books, papers, records, or other data, the United States district court for the district in which such person resides or is found shall have jurisdiction by appropriate process to compel such attendance, testimony, or production of books, papers, records, or other data.

* * * * *

Office-Supreme Court, U.S.
FILED
APR 15 1983
ALEXANDER L. STEVAS,
CLERK

No. 82-687

In the Supreme Court of the United States

OCTOBER TERM, 1982

UNITED STATES OF AMERICA, PETITIONER

v.

ARTHUR YOUNG & COMPANY, ET AL

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

JOINT APPENDIX

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PETITION FOR WRIT OF CERTIORARI FILED, OCTOBER 20, 1982
CERTIORARI GRANTED, FEBRUARY 22, 1983

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DOCKET ENTRIES

Date	Proceedings
10/12/79	Filed government's affidavit & petition to enforce & show cause order requiring respondent to appear in room 506 at 10:30 A.M. on 10/30/79 at USCH, N.Y.N.Y. Duffy, J. Filed government's memo in support
10/31/79	Filed stipulation & order that Arthur Young & any intervening party have until 11/6/79 to file responsive papers. & petitioners hearing is adjourned to 11/13/79. Cooper, J.
11/30/79	Filed affidavit of Robert G. Morvillo attorney for respondent in support of motion to intervene & show cause order, petitioner to appear at USCH S.D. N.Y.N.Y. on 12/4/79 at 10:30 A.M. room 506. Cooper, J.
112/5/79	Filed respondent's affidavit & notice of motion for a stay in this proceeding., Returnable 12/18/79 rm. 506 at 10:30 A.M. at USCH, N.Y.N.Y. Filed memo of law.
12/12/79	Filed stipulation & order adjourning hearing as follows., Respondent 12/26/79 for Responsive papers, Petitioner shall have until 1/4/80 to file reply papers and hearing on petitioner's application is adjourned to 1/8/80 part 1 rm. 506 at 10:30 A.M. Gagliardi, J.
12/17/79	Filed affidavit of Katherine J. Trager. Filed government's memo of law in opposition to motion for a stay or transfer of this proceeding.
12/28/79	Filed answer to petition to enforce IRS Summons. Filed memo in opposition to petitioner's request to enforce IRS.
12/31/79	Filed notice of deposition of Kenneth J. Kalemba. Filed Affidavit in opposition of Roger B. Oresman. Filed memo of Amerada Hess in opposition to petition seeking enforcement
1/7/80	Filed affidavit of Katherine J. Trager. Filed supplemental affidavit of G. Robt. Armstrong. Filed affidavit of Kenneth J. Kalemba. Filed affidavit of Anthony Caputo. Filed government's memo of law in support of petition to enforce an IRS Summons.
1/8/80	Filed affidavit of Robt. G. Morvillo. Filed transcript of record of proceedings dated 12/19/79 before Hon. Werker.
1/8/80	Filed memo endorsed on notice of motion filed 12/5/79., Motion denied. D[illegible] J.
1/11/80	Filed affi[illegible]t in response to government's memo of law by respondent. Filed surreply memo of Arthur Young & Co.

Date	Proceedings
2/16/80	Filed rebuttal affidavit of Katherine J. Trager
4/14/80	Filed transcript of record of proceedings dated 12/19/79 before Werker, J.
6/18/80	Filed supplemental memo of law in support of petition to enforce an IRS summons by govt.
8/26/80	Filed transcript proceedings dated 6/17/80 before Duffy, J.
8/28/80	Filed opinion #50511., Respondent is directed to comply w/IRS summons of 4/17/78 directing it to make available requested documents pertaining to Amerada Hess as indicated. Duffy, J.
9/9/80	Filed stipulation & order that time to move by Respondent is extended from 8/26/80 to 9/19/80. Carter, J.
9/22/80	Filed affidavit of Robert G. Morvillo, Esq. & notice of motion for reargument & relief from order of 8/26/80. Returnable 10/28/80 at 10:00 A.M. at USCH N.Y.N.Y. Rm. 443 Filed memo in support of motion. Filed Appendix to affidavit of Robt. G. Morvillo volume 1-2 Before Judge Duffy.
11/7/80	Filed government's stipulation & order returnable 12/2/80 at 10:00., Petitioners responsive papers shall be served before 11/24/80 as indicated. Duffy, J.
11/25/80	Filed affidavit of Anthony Caputo & G. Robert Armstrong. Filed memo of law in opposition to motion for reargument of & relief from Courts order of 8/26/80.
12/8/80	Filed reply memo of Robt. Morvillo
1/8/81	Filed memo endorsed on notice of motion for reargument filed 9/22/80., Motion for reconsideration is granted my original is adhered to & reaffirmed. Duffy, J.
2/9/81	Filed notice of substitution of counsel., That Wm. M. Tendy acting USA is to substitute John S. Martin for petitioner and it is effective nunc pro tunc as to all papers previously filed in this proceeding.
*1/30/81	Filed government's affidavit, copy of order & judgment & notice of motion for clarification of Courts 8/26/80 opinion., Returnable 2/9/81 rm. 443 at 9:30 A.M. at USCH, N.Y.N.Y. Order & Judgment signed by Duffy, J.
2/24/81	Filed memo endorsed on notice of motion filed 1/30/81. There being no opposition, Motion is granted. Duffy, J.

Date	Proceedings
2/26/81	Filed order & judgment that Courts opinion dated 8/26/80 be modified to delete therefrom the word "workpapers" from last line of page 12 & from fifth line of page 14., and that the petition of USA to enforce IRS summons on respondent Arthur Young & Co. on 4/17/78 is granted to extent set forth as indicated Duffy, J.
3/2/81	Filed stipulation & order that execution of order & judgment is stayed pending determination of appeal as indicated. Knapp, J.
3/9/81	Filed notice of appeal by Respondent Arthur Young & Co., & by Respondent-Intervenor Amerada Hess Corp.
3/12/81	Filed letter dated 2/9/81 from Arthur addressed to Hon. Kevin T. Duffy & signed by Carl D. Liggio.
3/13/81	Filed stipulation & order making various documents a part of the records as indicated. Duffy, J.

Docket No. M-18-304
Judge: Duffy

UNITED STATES OF AMERICA, PETITIONERS-APPELLEE,

v.

ARTHUR YOUNG & COMPANY, RESPONDENT-APPELLANT,

AND

AMERADA HESS CORPORATION,
RESPONDENT-INTERVENOR-APPELLANT

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No. M-18-304
Judge: (KTD)

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

UNITED STATES OF AMERICA, PETITIONER-APPELLEE

v.

ARTHUR YOUNG & COMPANY, RESPONDENT-APPELLANT

and

AMERADA HESS CORPORATION,
RESPONDENT-INTERVENOR-APPELLANT

CLERK'S CERTIFICATE

I, RAYMOND F. BURGHARDT, Clerk of the District Court of the United States for the Southern District of New York do hereby certify that the certified copy of docket entries lettered A-U, and the original filed papers number 1 thru 48, inclusive constitute the record on appeal in the above entitled proceedings except for the following missing documents:

DATE FILED	*PROCEEDINGS*
11/25/80	Memorandum of law of the United States in opposition to the motion for reargument
12/8/80	Affidavit of Robert G. Morvillo in response to affidavits in opposition to motion for reargument

IN TESTIMONY WHEREOF, I have caused the seal of the said Court to be hereunto affixed, at the City of New York, in the Southern District of New York, this 16th day of March, in the year of our Lord, One thousand nine hundred and eighty one.

/s/ RAYMOND F. BURGHARDT
Clerk of the Court

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

M-18-304

UNITED STATES OF AMERICA, PETITIONER

v.

ARTHUR YOUNG & COMPANY, RESPONDENT

**PETITION TO ENFORCE
INTERNAL REVENUE SERVICE SUMMONS**

The United States of America, by its attorney, Robert B. Fiske, Jr., United States Attorney for the Southern District of New York, alleges on information and belief:

1. This is a proceeding brought under the authority of Section 7402(b) and 7604(a) of the Internal Revenue Code of 1954, 26 U.S.C. §§ 7402(b) and 7604(a), judicially to enforce an Internal Revenue Service summons.

2. The respondent, Arthur Young & Company, is a corporation authorized to do business within the State of New York with an office for the transaction of business located at 277 Park Avenue, New York, New York, within the jurisdiction of this Court.

3. G. Robert Armstrong is employed as a Special Agent in the Office of the District Director of Internal Revenue, Newark District, with a post of duty at Asbury Park, New Jersey.

4. Special Agent Armstrong is conducting an investigation with Revenue Agent Anthony Caputo, a purpose of which is to ascertain the correctness of the tax return filed by Amerada Hess Corporation for the 1972, 1973, and 1974 tax years. The nature of this investigation is more fully set forth in the Special Agent's affidavit, annexed as Exhibit A.

5. The respondent is in possession or control of books, records and other papers or has knowledge relating to the above described investigation.

6. On April 17, 1978, an Internal Revenue Service summons, a copy of which is annexed as Exhibit B, was duly issued directing the respondent to appear to testify and pro-

duce for examination books, records and other papers more fully described in the summons. A copy of this summons was served on the respondent, through Carl D. Liggio, as counsel for Arthur Young and Company, at the time and in the manner indicated on Exhibit B at page 2.

7. The books, papers, records or other data sought by the summons are not in petitioner's possession.

8. In this proceeding, petitioner seeks production of the records and documents described in numbered items 1 through 5, 7 through 10, 12 through 17 of the summons. The testimony and documents sought may be relevant to and can reasonably be expected to cast light upon the correctness of the tax returns filed by the taxpayer for the years under investigation.

9. In accordance with Section 7609(a) of the Internal Revenue Code of 1954, 26 U.S.C. § 7609(a), notice of service of the summons and copies of the summons were sent to the taxpayer by registered or certified mail on April 18, 1978, as is indicated on Exhibit B at page 2.

10. By letter dated April 21, 1978, the taxpayer directed resondent not to comply with the summons. A copy of this letter is attached as Exhibit C.

11. Respondent did not appear on the return date of the summons, and its refusal to comply with the summons continues to date.

12. It is the practice of this Court to proceed by Order to Show Cause in these matters.

13. No previous application has been made for the order or relief sought.

WHEREFORE, the petitioner respectfully prays:

1. That this Court enter an order directing the respondent to show cause why the respondent should not comply with and obey the attached summons;

2. That this Court enter an order directing the respondent to obey the summons by ordering the production of the records called for in items 1 through 5, 7 through 10, and 12 through 17 of the summons before any proper officer of the Internal Revenue Service, at such time and place as hereafter may be fixed by such officer and by ordering the respondent to appear for the purpose of giving testimony

concerning the correctness of the taxpayer's tax returns as to each or any of the years under investigation; and

3. That this Court grant such other and further relief as it deems just and proper.

Dated: New York, New York
October 5, 1979

ROBERT B. FISKE, JR.
UNITED STATES ATTORNEY FOR THE
SOUTHERN DISTRICT OF NEW YORK
ATTORNEY FOR PETITIONER

/S/ KATHERINE J. TRAGER

KATHERINE J. TRAGER, Special
Assistant United States Attorney
Office and Post Office Address:
One St. Andrew's Plaza
New York, New York 10007
Telephone: (212) 791-9165

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

M-18-304

UNITED STATES OF AMERICA, PETITIONER,

v.

ARTHUR YOUNG & COMPANY, RESPONDENT

STATE OF NEW YORK)
: SS.:
COUNTY OF NEW YORK)

AFFIDAVIT

G. ROBERT ARMSTRONG, being duly sworn deposes and says:

1. I am employed as a Special Agent in the Office of the District Director of Internal Revenue, Newark District, with a post of duty at Asbury Park, New Jersey.

2. In my capacity as a Special Agent, I, together with Revenue Agent Anthony Caputo of the Examination Division, am conducting an investigation, one purpose of which is to ascertain the correctness of the tax returns filed by Amerada Hess Corporation (the "taxpayer") for the years 1972, 1973, and 1974.

3. This is a joint investigation conducted by the Examination and Criminal Investigation Divisions. The investigation is continuing. No recommendation for criminal prosecution has been made by the Internal Revenue Service to the Department of Justice with respect to the matters under investigation. Indeed, I have not yet made, and am not yet in a position to make, any recommendation one way or the other to my supervisor pending further investigation.

4. Before I joined the investigation in June, 1978, Special Agent Kenneth Kalemba issued an Internal Revenue Service summons directing the respondent to appear before him to testify and produce for examination the books, records and other documents described in the summons, a copy of which is annexed to the Petition as Exhibit B. This summons was issued as part of the investigation and with the approval of the Group Manager. (See Exhibit B.)

5. Thereafter, the summons was personally served on respondent at the time and in the manner indicated by Exhibit B at page 2.

6. In accordance with Section 7609(a) of the Internal Revenue Code of 1954, as amended, notice of service of the summons and copies of the summons were sent by certified or registered mail to the taxpayer in the manner indicated by Exhibit B at page 2.

7. Subsequently, the taxpayer instructed respondent not to comply with the summons. (See Exhibit C)

8. The respondent did not appear on the return date of the summons or otherwise comply with the summons. The refusal to comply with the summons continues to the date of this affidavit.

9. The books, records or other data sought by the summons are not in the possession of the Internal Revenue Service.

10. The taxpayer has disclosed that it maintained a fund called a "special disbursement account." From this fund, it made political contributions, some of which were reimbursed to the actual contributor, and charged to "legal fees," gave gifts to foreign government employees and deducted the same as "other deductions;" gave sums to members of local police and fire departments and deducted the same as "cleaning services," made payments, which were deducted, to a foreign "expeditor," and engaged in other possibly illegal activity. The taxpayer formed a Special Committee of its Board of Directors to investigate the practices of the corporation and its subsidiaries with respect to cash funds, payment to foreign government officials, and illegal, nondeductible, or questionable payments. A Report to the Board of Directors by the Special Committee regarding the questionable payments disclosed the respondent's participation in the Special Committee's investigation. Further, during the tax years in question, respondent received accounting fees from the taxpayer. The respondent has in its possession, custody or control the documents, records and other papers itemized in the summons and sought herein.

11. The following is a description of the items listed in the summons which are sought in this proceeding.

Numbered Item	*Description*

1. *Engagement Letter*—contract between the respondent and the taxpayer specifying what services the respondent is to perform, and in what areas the audit should be conducted.
2. *Management Letter*—letter from the respondent to the taxpayer describing the deficiencies in the taxpayer's records.
3. *Representation Letter*—letter from the respondent to the taxpayer informing the taxpayer's Board of Directors and the stockholders what financial records were audited.
4. *History File*—File concerning any item of importance having to do with the taxpayer, its divisions or subsidiaries.
5. *Standard Workpaper Index*—a preprinted form in which all workpapers of the respondent are indexed.
7. *Workpaper Review File*—List of the objectives of the audit and the employees of the respondent who worked on each area audited.
8. *Engagement Planning File*—internal memorandum of respondent, which discusses the areas which should be explored in the audit.
9. *Confirmation Control File*—contains checks of the accounts receivable and accounts payable by a letter out to the customers of the taxpayer asking for verification of certain amounts.
10. *Significant or Subsequent Events File*—document complied by the Senior or the In-Charge Accountant, who brings the audit up to date since the audit was completed. This document mentions any significant events that have happened since the time the audit was completed.
12. *Audit Workpapers File*—papers prepared by the respondent during its audit of the taxpayer.
13. Tax Pool Analysis File—(Tax Contingency File) File containing a memorandum, letter, or other document, which recommends to the taxpayer that

possible contingent liability for taxes be set up. For example, if the taxpayer had paid bribes overseas and this was discovered by the respondent, then the respondent would have the taxpayer set up a contingent liability for taxes. The contingent liability is created in case the Internal Revenue Service disallows the deduction for the bribes paid overseas.

14. Files prepared during the course of work performed for the Special Committee referred to above.
15. The names of the partner in charge, management partner and/or senior auditor of respondent who directed the audit of the taxpayer.
16. Any other information pertinent to the audit of taxpayer covering the years 1972, 1973, and 1974.
17. All workpapers, reports, records, correspondence, reconciliations and information relative to the United States Corporate Income Tax Returns (Forms 1120) of taxpayer that were prepared by respondent or under the supervision of respondent for the calendar years 1972, 1973 and 1974.

It is necessary to examine the documents, records and other papers described above and to take the testimony of respondent in order to ascertain the correctness of the tax returns filed by the taxpayer for the years under investigation.

/s/ G. ROBERT ARMSTRONG

G. ROBERT ARMSTRONG
Special Agent,
Internal Revenue Service

Sworn to before me this
19th day of July, 1979.

/s/ LAWRENCE MASON

LAWRENCE MASON
Notary Public

Form 2039
(Rev. 3-77)

Summons

In the matter of the tax liability of
AMERADA HESS CORPORATION
1 Hess Plaza
Woodbridge, New Jersey

Internal Revenue District of Newark

Periods 1972, 1973 and 1974

The Commissioner of Internal Revenue

To ARTHUR YOUNG & COMPANY Through CARL O. LIGGIO as Counsel for ~~as a partner of ARTHUR YOUNG & CO.~~ Arthur Young & Co.
277 Park Avenue
At New York, New York

You are hereby summoned and required to appear before Special Agent Kenneth J. Kalemba an officer of the Internal Revenue Service, to give testimony relating to the tax liability or the collection of the tax liability of the person identified above for the periods shown and to bring with you and produce for examination the following books, records, papers, and other data:

See Attached

Business address and telephone number of Internal Revenue Service officer named above:

IRS, Intelligence Division, P.O. Box 1137, Asbury Park, NJ 07712 201-775-2700

Place and time for appearance:

at IRS, Intelligence Division, 970 Broad Street, Newark, NJ 07101 (Room 1404)

on the 4 day of MAY 19 78 at 11 or o'clock A M.

Issued under authority of the Internal Revenue Code

this 17 day of April 19 78

Kenneth Kalemba
Signature of Issuing Officer — Special Agent, Title

John Kinnear by KJK
Signature of Approving Officer (if applicable) — Group Manager, Title

Original to be retained by IRS

EXHIBIT B

Form 2039 (Rev. 3-77)

Certificate of Service of Summons and Notice

(Pursuant to section 7603, Inter. Revenue Code)

I certify that I served the summons shown on the front of this form on:

Date	Time
4/17/78	10.30 AM

How Summons Was Served

☒ I handed an attested copy of the summons to the person to whom it was directed.

Carl D. Liggio

☐ I left an attested copy of the summons at the last and usual place of abode of the person to whom it was directed. I left the copy with the following person (if any).

Signature: Kenneth Kaleda

Title: Special Agent

This certificate is made to show compliance with section 7609, Internal Revenue Code. This certificate applies only to summonses served on third-party recordkeepers and not to summonses served on other third parties or any officer or employee of the person to whose liability the summons relates nor to summonses in aid of collection, to determine the identity of a person having a numbered account or similar arrangement, or to determine whether or not records of the business transactions or affairs of an identified person have been made or kept.

I certify that, within 3 days of serving the summons, I gave notice (Form 2039-D) to the person named below on the date and in the manner indicated.

Date of Giving Notice: 4/18/78 Time: Mail

Name of Noticee: Carl T. Tursi, Secretary - Amerada Hess Corp

Address of Noticee (if mailed): 1185 Ave. Americas, N.Y.C.

How Notice Was Given

☒ I gave notice by certified or registered mail to the last known address of the noticee.

☐ I gave notice by handing it to the noticee.

☐ I left the notice at the last and usual place of abode of the noticee. I left the copy with the following person (if any).

☐ In the absence of a last known address of the noticee, I left the notice with the person summoned.

☐ No notice is required.

Signature: Kenneth Kaleda

Title: Special Agent

Form 2039 (Rev. 3-77)

The Following Documents Relating To Amerada Hess Corporation

All For The Years 1972 Through 1974:

1. Engagement letter(s)
2. Management letter(s)
3. Representation letter(s)
4. History file(s)
5. Standard workpaper index(s)
6. Administrative file(s)
7. Workpaper review file(s)
8. Engagement planning file(s)
9. Confirmation control file(s)
10. Significant events file(s)
11. Audit program file(s)
12. Audit workpaper's file(s)
13. Tax pool analysis file(s)
14. File(s) prepared during the course of work performed for the "special committee", including agreed procedures, selection process, reports, schedules and other workpapers
15. The name of the partner in charge, engagement partner and/or senior auditor who directed the audit of Amerada Hess Corporation
16. Any other information pertinent to the audit of Amerada Hess Corporation covering the years 1972, 1973 and 1974
17. All workpapers, reports, records, correspondence, reconciliations and information relative to the United States Corporate Income Tax Returns (Forms 1120) of Amerada Hess Corporation that were prepared by Arthur Young & Company or under the supervision of Arthur Young & Company for the calendar years 1972, 1973 and 1974.

UNITED STATE DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

Civil Action No. 79–1805

UNITED STATES OF AMERICA, PETITIONER

v.

ARTHUR YOUNG & COMPANY, RESPONDENT.

ANSWER OF RESPONDENT-INTERVENOR AMERADA HESS CORPORATION TO PETITION TO ENFORCE INTERNAL REVENUE SERVICE SUMMONS

Respondent-intervenor Amerada Hess Corporation (hereinafter "Amerada") as its answer to the petition, alleges as follows:

I. Admits the averments contained in paragraphs 1, 2, 3, 9, 10 and 13.

II. Denies the averments contained in paragraphs 4 and 3.

III. Admits upon information and belief the averments contained in paragraphs 6 and 11.

IV. Denies knowledge or information sufficient to form a belief as to the averments contained in paragraphs 7 and 12.

V. Denies the averments contained in paragraph 8 except admits that the petitioner in this proceeding seeks the documents referred to in paragraph 8.

AFFIRMATIVE DEFENSES

FIRST: The summons was not issued in good faith because it was issued solely for the purposes of gathering evidence for a criminal prosecution of Amerada and the Internal Revenue Service had no intention of pursuing any civil remedies with regard to the matters raised in the petition.

SECOND: The summons was not issued in good faith because it was issued to harrass and punish respondent-intervenor for its failure to cooperate with the aforesaid criminal investigation.

THIRD: The summons is unduly broad and burdensome and seeks documents that are not relevant to any legitimate tax inquiry.

FOURTH: The documents sought in paragraph 14 of the summons are protected by the work-product privilege.

FIFTH: The Internal Revenue Service is as a matter of law and policy not entitled to the documents requested in paragraph 13 of the summons. *United States* v. *Coopers & Lybrand*, 550 F.2d 615 (10th Cir. 1977).

SIXTH: The long delay in instituting this enforcement proceeding constitutes a waiver of any rights petitioner may have had to compel enforcement of the summonses.

WHEREFORE, the respondent-intervenor respectfully prays:

1. That this Court enter an order dismissing the petition.
2. That this Court render such other and further relief as is just and proper.

Dated: New York, New York
November 29, 1979

MILBANK, TWEED, HADLEY & McCLOY
One Chase Manhattan Plaza
New York, New York 10005

/S/ ROBERT G. MORVILLO
OBERMAIER, MORVILLO,
ABRAMOWITZ & FITZPATRICK
1290 Avenue of the Americas
New York, New York 10019

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

M-18-304

UNITED STATES OF AMERICA, PETITIONER

v.

ARTHUR YOUNG & COMPANY, RESPONDENT

and

AMERADA HESS CORPORATION, INTERVENOR.

ANSWER TO PETITION TO ENFORCE INTERNAL REVENUE SERVICE SUMMONS

ARTHUR YOUNG & COMPANY ("Arthur Young"), by its attorney, Carl D. Liggio, answers the petition as follows:

1. It admits the allegations of paragraphs 1, 9, 10, and 13 of the Petition.

2. It denies the allegation of paragraph 2 that Arthur Young is a corporation, but admits that Arthur Young is a partnership doing business within the State of New York with its principal place of business located at 277 Park Avenue, New York, New York, within the jurisdiction of this Court.

3. It is without sufficient information to admit or deny the allegations of paragraphs 3, 4, 5, and 12.

4. It admits that on April 17, 1978, an Internal Revenue summons, a copy of which is annexed as Exhibit B to the Petition, was issued directing Arthur Young to appear to testify and produce the documents described in the summons and that a copy of this summons was served on the respondent through Carl D. Liggio, as counsel for Arthur Young and Company, at the time and in the manner indicated on Exhibit B to the Petition, but except as admitted herein denies paragraph 6 of the Petition.

5. It denies the allegations of paragraph 7 of the Petition.

6. It admits that petitioner now purports to seek only production of the records and documents described in items 1 through 5, 7 through 10, and 12 through 17 of the sum-

mons, but except as admitted denies the remaining allegations of paragraph 8 and avers that the demands of items 12 and 16 are so broad as to include items 6 and 11.

7. It admits the allegation of paragraph 11 that respondent did not appear on the return date of the summons, but avers that it has attempted to reach a good faith resolution of this matter with petitioner who has refused to do so.

AFFIRMATIVE DEFENSES

First: The summons is invalid as it exceeds the statutory authority of the Internal Revenue Service.

Second: The summons is burdensome and harassing.

Third: The summons should not be enforced except to the extent it seeks relevant data at the location where such data is kept and the IRS tenders to Arthur Young the full costs of compliance of the subpoena.

Fourth: As a matter of policy the IRS should not be entitled to certain documents it seeks from Arthur Young.

Fifth: Certain documents sought by the IRS are immune from production.

Sixth: The IRS delay in seeking enforcement of the summons constitutes a waiver of its right to seek enforcement.

WHEREFORE, Arthur Young respectfully prays:

1. That this Court deny petitioner's request or in the alternative enter a protective order as more fully set out in respondent's papers, and

2. That this Court grant such other and further relief as it deems just and proper.

Dated: December 28, 1979
New York, New York

/s/ CARL D. LIGGIO

CARL D. LIGGIO
General Counsel
Arthur Young & Company
277 Park Avenue
New York, New York 10017
(212) 922-2465

UNITED STATES DISTRICT COURT
SOTHERN DISTRICT OF NEW YORK

M-18-304

UNITED STATES OF AMERICA, PETITIONER,

v.

ARTHUR YOUNG & COMPANY, RESPONDENT,

and

AMERADA HESS CORPORATION, INTERVENOR

STATE OF NEW YORK)
) SS.:
COUNTY OF NEW YORK)

AFFIDAVIT

CARL D. LIGGIO, being duly sworn, says:

1. I am General Counsel of Arthur Young & Company ("Arthur Young") and member of the Bar of this Court. This Affidavit is made in opposition to the Petition of the Internal Revenue Service ("the Service") to enforce a Summons Duces Tecum served on Arthur Young some 21 months ago.

2. The Government proceeded by Order to Show Cause on October 9, 1979 even though it had done nothing with respect to the summons for some 18 months. In support of the petition is an Affidavit of G. Robert Armstrong, Special Agent of the Internal Revenue Service, dated the 19th of July, 1979 (the "Armstrong Aff."), executed some three months prior to the date that the Government moved by Order to Show Cause.

3. The IRS seeks to enforce a summons for virtually every document in Arthur Young's files relating to the audits and tax return work done for Amerada Hess Corporation ("Amerada") for the periods 1972 through 1974. The documents called for by the summons are kept at two locations, New York City and Tulsa, Oklahoma. They comprise over 700 workpaper binders plus correspondence files. Based on

my prior experience with Arthur Young workpapers, I estimate that the summons seeks over 250,000 pages.

THE ISSUES

4. At the outset, it is important to note what this case is not about as much as what it is. Given the pejoratives used in the Armstrong Aff. to describe Amerada and certain of its purported activities and in arguments of government counsel on the motion for a stay or transfer, one would suspect that this case involves issues of fraud and that Arthur Young's refusal to produce the workpapers is only an attempt to conceal certain nefarious activities on the part of its client. This is neither the case, *see* Affidavit of Roger Oresman sworn to on December 28, 1979 (the "Oresman Aff."), nor the reason for Arthur Young's noncompliance which is based solely on policy reasons (*see* discussion, *infra*).

5. Procedurally, the case is in part before this Court because Amerada exercised its rights pursuant to Section 7609 of the Internal Revenue Code to object to the production of documents by Arthur Young, a third-party recordkeeper. But even if Amerada had not intervened and filed an objection under Section 7609, Arthur Young would still have objected to the summons and the parties would in all likelihood be before this Court.

6. The reason for this is simple. Arthur Young believes that the Service has overstepped its authority in serving this broad-based summons seeking all the documents in Arthur Young's files relating to Amerada and, particularly, in its attempt to obtain the tax accrual workpapers, a matter discussed in substantially more detail in paragraphs 17 to 31 of this Affidavit.

THE BACKGROUND

7. Arthur Young has been Amerada's independent auditor since November 1, 1971. It conducted audits of Amerada's financial statements for the calendar years 1972, 1973, and 1974 (the tax years at issue). In 1976 Amerada's Board voluntarily established a Special Committee to determine whether there had been an improper use of corporate funds. It also retained its counsel, Milbank, Tweed,

Hadley, & McCloy ("Milbank Tweed"), in this project and retained Arthur Young to assist Milbank Tweed. Arthur Young did assist in this investigation and prepared files—29 workpaper binders—which were used by Milbank Tweed in providing legal advice to the Special Committee.

8. An Arthur Young partner, Theodore Romak, also signed the Amerada tax returns for the years in question even though Arthur Young was not the tax return preparer and IRS Practice guidelines did not require it to sign the tax return. However, both as a condition of the engagement by Amerada and under the AICPA's Standards of Professional Responsibility for Tax Return preparers, Romak signed the returns in question.

9. On Monday, April 17, 1978, Kenneth J. Kalemba, a Special Agent for the Service, served a summons on me for all the documents in Arthur Young's files relating to Amerada. When Mr. Kalemba served the summons, I quickly reviewed it and advised him that the summons appeared overly broad and raised significant policy issues which mandated our Firm's non-compliance with it. There were several reasons why I believed this, all of which I advised Mr. Kalemba of at that time. These were:

1. It violated the IRS's own procedural manuals;
2. It was overbroad and could not be totally relevant to any proper inquiry;
3. It was burdensome and harrassing as it, among other things, requested documents to be produced other than at their locations;
4. It sought our tax accural papers and audit programs which is inconsistent with prior Federal case law.

10. I also advised Mr. Kalemba that nothwithstanding this, we were willing to cooperate with the Service in producing documents relevant to its investigation provided, of course, that the Service was reasonable in its request. I told Mr. Kalemba that if he identified specific, relevant subject matters, Arthur Young stood ready to assist and cooperate with the Service subject, of course, to the legal restrictions otherwise imposed upon Arthur Young by Federal law.

11. Following this conversation with Mr. Kalemba, I reiterated this in a telephone conversation on Thursday, April 20, 1978 and further confirmed it in a letter to him on April 25, 1978, a copy of which is attached as Exhibit A to this Affidavit. In that letter I stated:

> "As we further discussed when I met with you on April 17, I will be out of the area May 4, 1978, and thus unable to appear at the return date as established. You indicated that because of our position with respect to the production, there was no need to appear and that the date was selected only to start the statutory period running."

12. Nothing further was heard from the Service until I was served with the Order to Show Cause in October, 1979. Subsequently, I had several conversations with Ms. Trager, the Assistant U.S. Attorney representing the Service, in an attempt to reach a resolution of the issues or at least to narrow the issues in dispute. During one of these conversations, I advised Ms. Trager that Arthur Young was prepared to make a production of relevant materials and to enlist our client's permission in making that production notwithstanding its 7609 objection, if the Service was prepared to identify by subject matter those areas in which it was interested. In response to this Ms. Trager advised me that she would consult with the special agents to see if this could be done. She subsequently advised me on November 27, 1979 that the agents did not know what they wanted and that they, therefore, needed to look at everything.

13. Arthur Young's objections to the production of the materials called for by the summons are several. Most were stated orally to Mr. Kalemba as noted above, and in writing by my letter dated April 25, 1978. More fully, they are as follows:

A. *The breadth of the summons:* The Service should not be entitled to obtain from a third party every piece of paper in its files just by asking for it. It believes the request must be reasonably specific and that some basic showing of relevance must be made to justify such an extensive production.

B. *The tax accrual papers:* Except in the rarest possible instances, which are not present here, the Service should not be entitled to have access to an auditor's tax accrual workpapers.

C. *Privileged materials:* Certain of the materials are privileged. They were either prepared for or compiled in conjunction with work performed by attorneys. If the Service is entitled to have access to that material, it will seriously limit the ability of lawyers to obtain needed assistance from other professional disciplines when providing legal services to their clients.

D. *Audit Programs and Plans:* These constitute trade secrets and provide no relevant information to the correctness of the tax returns.

E. *The burden and cost of compliance:* The Service seeks approximately a quarter of a million documents to be produced in New Jersey from locations in New York and Tulsa, Oklahoma. It does not offer compensation for the substantial burden that is imposed on Arthur Young in complying with this summons.

The most significant objection, however, is to the Service's request for Arthur Young's tax accrual workpapers. In order to understand the significance of the tax accrual papers it is important to understand what they are and the reason for their preparation.

THE AUDIT FUNCTION

14. The function of an audit is to provide an independent look at the representations of management to the stockholders and others as to stewardship of the business. Management's representations are contained in the financial statements. The auditor performs his audit in accordance with Generally Accepted Auditing Standards ("GAAS"). He utilizes those procedures which he believes are necessary in order to comply with GAAS and to permit him, upon completion of the audit, to render an opinion on the financial statements taken as a whole. To do this the auditor must review the various components of the financial statements. The auditor must test and review underlying sup-

porting documentation, obtain representations from management, and make an independent evaluation as to the correctness of the presentation in the financial statements when they are considered as a whole. This examination is conducted pursuant to an Audit Plan and Audit Programs prepared by the auditor which are trade secrets of the auditor.

15. Notwithstanding the fact that financial statements are a compilation of numbers, they are not expressions of mathematical certainty. Each financial statement represents many judgments by management and correspondingly by the auditor who must review those financial statements. For example, the fact that receivables are shown on the financial statements in an amount of $5,000,000 does not mean that the receivables will in fact produce $5,000,000 of receipts. There could be subsequent returns and credits issued against those receivables, debtors might decide not to pay because the product was defective and claim an offset, or because of poor business the debtor may be unable to pay and may, in fact, go into bankruptcy.

16. Management must make an evaluation of all of these possibilities and establish a reserve against those receivables to account for these possibilities. The auditor must make judgments as to the adequacy of the reserves and the procedures employed by management in establishing those reserves. It is very unlikely that the management or auditor's judgment as to the reserve will ever be 100% accurate. One cannot judge with any degree of certainty how many customers may fall on hard times and be unable to pay, what product defects might exist, etc. However, there usually exist some general criteria and some general guidelines from past experience of a particular company. Based on this a reserve is established by management and reviewed by the auditors. In the final analysis, however, this process involves the exercise of judgment. Both the auditor and management must go through this process for many items in the financial statements.

17. Similarly, one of the items in the financial statements which requires this judgmental process are the tax liability accounts. These accounts represent taxes currently due or due in the future—deferred taxes. The audit of the tax liability accounts is to see if the amounts shown, which are in many cases estimates, are reasonable. The purpose of the tax accrual review is materially different from work performed in preparing tax returns.

18. Financial accounting under Generally Accepted Accounting Principles ("GAAP") is different from the tax accounting. For example, a business may elect to take accelerated depreciation on a piece of equipment it had purchased, which is permissible under the tax code. However, for financial reporting purposes the effect of the tax deferral on current income from accelerated depreciation must be disregarded. Accordingly, the tax actually paid by a company using accelerated depreciation will be substantially less in the current year and substantially greater in future years. This creates what is known as a timing difference for taxes. The company will pay less taxes currently but more taxes in subsequent periods. For the financial statements to more clearly reflect the current period cost, a charge must be established currently for the deferred taxes to represent that portion of the taxes which would be paid but for the use of accelerated depreciation. Correspondingly, when the larger amount of taxes are paid in future periods they will not affect the then current income because they will be debited against the deferred tax account. This is a timing difference. The auditor must be sure that Management has accounted for it in preparing the financial statements.

19. In addition all major companies are audited annually by the Service. Quite often the Service will take positions different from those taken by the taxpayer in good faith. This results in a tax dispute which leads to a Revenue Agent's Report ("RAR") and, in turn, could lead to litigation or compromise with the Corporate entity subsequently paying more taxes if the RAR prevails. Sometimes the

Service will prevail, sometimes it will not (and sometimes the taxpayer will counterclaim for a refund and prevail); but more often the matter will be compromised by the taxpayer and Service. In auditing the financial statements, the auditor must take into account the possibility of adjustments being determined on audit by the IRS. This possibility must then be estimated and quantified and looked at from the standpoint of the amount of the reported taxes on the financial statements.

20. Adjustments by the Service can result from any number of things:

- They can result from an error found in the accounting records;
- They can result from a change in the case law occuring after the tax return was filed;
- They can result because the Service interprets the law or regulations applicable to the transaction in a different manner from the taxpayer;
- They can result because there are honest differences of judgment with respect to the transactions in question.

21. A typical example of an RAR involving oil companies is what is known as the "Delineation Wells Issue." The Delineation Wells Issue* arose several years ago when oil companies began drilling offshore. Unlike domestic drilling where the drill site will be completed as a production well and the allocation of costs between intangible ("IDC") and tangible drilling and Geological and Geophysical ("G&G") costs are relatively clear, oil companies would usually not complete their offshore test well which is usually drilled from a moving platform, but would drill their completion wells elsewhere. (IDC is currently deductible, but tangible drilling costs on a producing well must be capitalized and written off over the expected production of the well and G&G is capitalized as part of the leasehold and cost depleted.) Accordingly, the oil companies would treat all ex-

* Delineation Wells are used to determine the location of the oil and gas reservoir.

ploratory well costs as IDC entitling them to immediate deductibility of those costs. The Service has uniformly disallowed these costs. In a test case* before the tax court, *In re Standard Oil Co. (Indiana)*, 68 T.C. 28 (1977) (CCH) Dec. ¶ 34,442 ("the *Amoco* case"), the oil companies prevailed and the Service did not appeal! Nothwithstanding this, the Service has continued to disallow Delineation Well expenses on audit and continues to claim increased taxes. Management must make a judgment as to how these transactions will affect their tax liability: e.g. whether the IRS will ultimately win in another case or whether to avoid the expense of litigation, the company may be willing to reach a compromise with the IRS notwithstanding the fact that the Tax Court has ruled squarely for the oil companies. It must then either accrue for that potential liability or make a judgment that no liability will occur. Next the auditor must review that accrual to see if he concurs with management's evaluation, and if not, whether their differences are material. The tax accrual workpapers will reflect this judgmental process.

22. The auditors in evaluating these types of transactions and their impact on the financial statements must make many judgments themselves. They must review the reasonableness of the position taken by the client and the reasonableness of the positions expected to be taken by the Service; and as to prior returns, where an RAR has been issued, the reasonableness of the Service's position on the RAR. They must view the likelihood of success of each of these positions. They must also take into account the client's disposition with respect to responding to RAR's. Is the client one that is likely to litigate to the bitter end or roll over at the slightest sign of pressure nothwithstanding the validity of the taxpayer's position, or is it likely to try to settle on a reasonable basis; and if so, what would it consider a reasonable basis and what additional taxes is the client prepared to pay if it is unsuccessful?

**Subsequently in a private ruling the Service has taken the novel position that Delineation Wells cost were neither IDC, tangible costs nor G&G, but were costs of a different category, amortizable over the life of the field.

23. Ideally if the auditor could have access to the Service's views on these positions once it had all the facts, life would be simpler. It would know where a compromise is likely to be struck, and thus more realistically estimate or determine what the taxpayer's likely tax will be and what should be contained in the tax account.

24. Obviously, however, the Service does not want to share such information with the auditors any more than the taxpayer wants to share its views on those subjects with the Service. The Service believes that to do so would seriously weaken its ability to resolve the RAR. Correspondingly the client does not want that similar information to be made available to the IRS for the very same fears that its ability to strike a reasonable settlement on good faith judgments that it has made will be seriously impaired. It would create an unequal bargaining power in an area which is legitimately judgmental.

25. Another area which the auditor must consider is the possibility for challenges to the tax treatment of transactions by some new or novel theory. In doing so the auditor must play devil's advocate. He must look at the totality of the transactions to see if there are some things there that on any theory might be challenged—not that they ever would be challenged or even if challenged, successfully challenged. The result of this is that the auditor generates a series of positions from the highly likely to the most unlikely with respect to tax positions the Service could take. If the Service were to have this analysis, it would provide a basis for challenge to the taxpayer regardless of the merits of the challenge. The taxpayer, confronted with all of these challenges would, because of the risk of litigation, be forced to compromise otherwise valid positions.

26. For the auditor to make those evaluations he must review a multitude of facts in the company's records. He must talk to company personnel and he must be current in the tax laws, their ramifications, and significance. The tax accrual papers reflect the opinions and judgments of the auditors after all this has been done. There is no factual data relating to Amerada transactions in the tax accrual papers which is not otherwise available in the taxpayer's records

or in publicly available documents. (*See, infra* ¶ 31 and Exhibit B attached hereto.)

27. Thus it can be readily seen that permitting the Service access to the tax accrual workpapers would be seriously detrimental to the taxpayer and the auditor and more importantly, to the auditor's relationship with his client. The fundamental function of the auditor, the testing and checking of the representations of management would be seriously impaired. Clients would be reluctant to provide necessary information in the area of the tax accruals for fear that the IRS would routinely obtain this information and then indiscriminately challenge every tax position taken by it. The devastating impact of this to the auditing profession and to the primary objective of that audit, the integrity of the financial statements, is obvious.

28. It is for this reason that Arthur Young, without regard to Amerada's wishes in this connection, objects to and challenges the Service's ability to obtain the auditor's tax accrual papers.

29. But even aside from these important reasons, the tax accrual papers have no relevance to the IRS audit. As noted above, there is no factual information as to Amerada transactions contained in the papers which is not otherwise available. The tax accrual papers are prepared for an entirely different purpose than the tax return and tax return papers. They are prepared so that the auditor may determine within accounting/reporting materiality guidelines that the provision for taxes is neither understated *nor*, for that matter, overstated in the financial statements.

30. The Armstrong Aff. attempts in a very limited capacity to justify some relevance for the tax accrual papers. On Page 4, item 13, Armstrong states that it is a file

> "containing a memorandum letter or other document which recommends to the taxpayer that the possible contingent liability for taxes be set up. For example, if the taxpayer had paid bribes overseas and this was discovered by the Respondent, then the Respondent would have the taxpayer set up a contingent liability for taxes. The contingent liability is created in case the Internal Revenue Service disallows the deduction for bribes paid overseas."

31. First, the Armstrong Aff. is factually inaccurate. As auditors, Arthur Young has no power to require the taxpayer to set up any contingent liability for taxes nor does it do so. It views the totality of the tax account to see whether it is reasonable and within materiality guidelines, and provides an adequate reserve for any future taxes the taxpayer may be required to pay. Second, we have carefully reviewed the tax accrual files for the period covered by this summons. There is nothing in these files dealing with disallowances for deductions for bribes paid overseas or any of the matters covered in the Special Committee's Report to the Board of Directors which is more specifically referred to in paragraph 10 of the Armstrong Aff. (pp. 2-3). Attached hereto is Exhibit B, an Affidavit of Bruce Greenwald, a partner currently responsible for the Amerada tax work at Arthur Young who at my direction reviewed the tax accrual files subject to the summons. Mr. Greenwald's Affidavit makes it clear no such information is contained in the tax accrual workpapers.

THE DEMAND FOR ALL ARTHUR YOUNG'S WORKPAPERS

32. The summons served on Arthur Young seeks 17 categories of document types. This effectively calls for every document in Arthur Young's files relating to Amerada without regard to its relevance to Amerada's tax return. Although the Service "appears" to have abandoned its requests for the document types in categories 6 and 11, the breadth of paragraphs 12 and/or 16 negate that purported abandonment. (In addition paragraph 8 for which enforcement is still sought may include paragraph 11.) In fact paragraphs 12 and 16 encompass all other paragraphs of the summons except paragraphs 14 and 17.

33. Arthur Young does not take the position that the Service is not be entitled to have access to some or, even many, of its workpapers, provided, of course, the Service acted within its legal authority. Rather, Arthur Young's position is that the Service may not effectively ask for every piece of paper in Arthur Young's files without regard to

relevancy* by describing generically the document types which it wishes to see. An example of this best illustrates Arthur Young'sposition.

34. Assume that the Service is investigating a specific transaction relating to whether the installment method of reporting a gain is appropriate. Under such circumstances there may be correspondence, memoranda and other workpapers recording and reflecting the transaction. A proper summons request would be for documents relating to the identified sales transactions. It would be improper to make a demand for all correspondence, memoranda and workpapers relating to XYZ Corp. The latter is a generic document request which is improper and should not be permitted. Accordingly, the Service's request for Arthur Young's "administrative file", "workpaper review file", "engagement planning file", "significant events file", etc. is the type of generic document request that Arthur Young submits is improper. Such a generic "document request" cannot be tested for relevancy either by a Court or a party trying in good faith to comply with a summons.

35. Another similarly over broad request is paragraph 16 which requests "Any other information pertinent to the audit of taxpayer covering the years 1972, 1973 and 1974." Not only is this request overly broad, but it is also unduly vague.

36. As noted above, Arthur Young does not argue that the Service cannot have access to its files. For example, of the 17 paragraphs of the summons one is, in Arthur Young's view, a proper subject matter request and documents would be produceable subject, of course, to the outcome of the other issues raised in this proceeding. This is item 17 which states:

> "All workpapers, reports, records, correspondence, reconciliations and information relative to the United States Corporate Income Tax Returns (Forms 1120) of Amerada Hess Corporation that were prepared by Arthur Young & Co. or under the supervision of Arthur

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*There are many workpapers which have absolutely nothing to do with Amerada's tax liability nor could they have anything to do with it even under the loosest standard of relevancy.

Young & Co. for the calendar year 1972, 1973, and 1974".

This request is obviously relevant to a specific subject matter which on its face is within the ambit of the Service's investigation—the preparation of the tax returns.

37. It is for the foregoing reasons that Arthur Young opposes this Petition and respectfully requests that this Court deny the Petition in its entirety or, in the alternative, to condition compliance on the Service identifying with particularity the subject matters of its inquiry and limiting production to documents pertinent to those subject matters; but in any event denying access to the tax accrual papers. Such production should be further conditioned on the Service reviewing the documents where they are kept by Arthur Young and tendering to Arthur Young the costs of compliance with the summons.

/S/ CARL D. LIGGIO
CARL D. LIGGIO

Sworn to before me this 28th day of December, 1979.

/S/ ANTHONY J. ZAGARINO
ANTHONY J. ZAGARINO
Notary Public

ARTHUR YOUNG & COMPANY

277 Park Avenue
New York, N.Y. 10017

April 25, 1978

Mr. Kenneth J. Kalemba
Special Agent
Internal Revenue Service
P.O. Box 1137
Asbury Park, NJ 07712

Re: *Amerada Hess Corporation*

Dear Mr. Kalemba:

This will confirm the oral statements I made to you on Monday, April 17, 1978 when you served me with a summons for documents in Arthur Young & Company's files relating to services we have performed for Amerada Hess. At the time you served me with the summons, I advised you that on its face it appeared to be overly broad and that it raised significant policy issues which mandated our non-compliance.

Now that I have had time to study the summons, I believe it appropriate to elaborate on those comments.

1. The summons calls for almost every piece of paper relating to Amerada Hess in the Arthur Young files. We believe this is inconsistent with the IRS' own procedural manuals, and in any event, is improper.

2. To the extent it seeks all papers indiscriminately, the summons is necessarily overly broad and without the statutory authority of the Service. It seeks papers that could not be relevant to any proper inquiry.

3. To the extent that it calls for virtually all of our workpapers, particularly on an audit the size of Amerada Hess, the summons is burdensome and harrassing. This is exacerbated by the fact that production of these materials is requested at the Service's offices in New Jersey.

4. To the extent that it attempts to identify specific types of papers such as "tax pool analysis," and "audit programs", we believe that the summons is inconsistent with

positions taken by Federal Courts and in direct contravention of the Service's own positions. *See e.g., U.S.* v. *Coopers & Lybrand*, 550 F.2d 615 (10th Cir. 1977).

As I indicated to you when we met and in a subsequent telephone conversation on Thursday, April 20, 1978, Arthur Young & Company always stands ready and willing to cooperate with the Service in producing relevant documents to its investigations, provided, of course, that the Service is reasonable in its request. To the extent that you are prepared to identify specific relevant matters to your investigation, Arthur Young stands ready and willing to cooperate and assist you subject, of course, to the strictures of § 7609 of the I.R.C. To the extent that you continue to press for compliance with a burdensome, harrassing, and improper summons, Arthur Young will resist all of your demands to the fullest extent possible within the framework of the legal system.

As we further discussed when I met with you on April 17, I will be out of the area May 4, 1978, and thus unable to appear at the return date as established. You indicated that because of our position with respect to the production, there was no need to appear and that the date was selected only to start the statutory period running.

Again, I wish to reiterate that we stand ready and willing to cooperate with you in a reasonable manner. Please feel free to call me to discuss this.

Very Truly yours,

CARL D. LIGGIO
General Counsel

cc: Amerada Hess Corp.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

M-18-304

UNITED STATES OF AMERICA, PETITIONER,

v.

ARTHUR YOUNG & COMPANY, RESPONDENT.

and

AMERADA HESS CORPORATION, INTERVENOR.

AFFIDAVIT

BRUCE M. GREENWALD, being sworn, says:

1. I am a partner with Arthur Young & Company ("Arthur Young") and a partner with responsibility for the tax work Arthur Young performs for Amerada Hess Corporation ("Amerada").

2. At the request of Carl D. Liggio, I reviewed the tax accrual workpapers prepared by Arthur Young in connection with its audits of Amerada for the years 1972, 1973 and 1974.

3. There is no information whatever in the tax accrual workpapers relative to any alleged bribes or other matters covered by the Special Committee's Report.

4. To the extent there is any actual data relating to Amerada's transactions in the tax accrual files, such data was derived from and can be found in Amerada's files or in publicly available documents.

/S/ BRUCE M. GREENWALD
BRUCE M. GREENWALD

Sworn to before me this 26th day of December, 1979.

/S/ ANTHONY J. ZAGARINO
ANTHONY J. ZAGARINO
Notary Public

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

M-18-304

UNITED STATES OF AMERICA, PETITIONER,

v.

ARTHUR YOUNG & COMPANY, RESPONDENT,

and

AMERADA HESS CORPORATION, INTERVENOR.

AFFIDAVIT IN OPPOSITION

STATE OF NEW YORK)
: ss.:
COUNTY OF NEW YORK)

ROGER B. ORESMAN, being duly sworn, deposes and says:

1. I am an attorney admitted to practice in the State of New York. I am a member of the firm of Milbank, Tweed, Hadley & McCloy, attorneys for Amerada Hess Corporation ("Amerada"), the intervenor in this proceeding.

2. I submit this affidavit in opposition to the petition of the Government for an order directing Arthur Young & Company ("Arthur Young"), the respondent, to comply with an Internal Revenue Service ("IRS") summons issued April 17, 1978 and calling for a mammoth production of certain records of Arthur Young. A copy of the summons is attached as Exhibit A.

3. Amerada's answer to the petition for enforcement of the summons, a copy of which is attached as Exhibit B, sets forth six affirmative defenses. They are:

a. that the summons was issued solely for a criminal purpose;

b. the summons was issued to harass Amerada;

c. the summons is overly broad and not relevant to any legitimate tax inquiry;

d. some of the documents are protected from disclosure by the attorney's work product doctrine;

e. the IRS is prohibited by law and public policy from discovering Arthur Young's tax accrual workpapers;

f. the delay between issuance and enforcement of the summons constitutes a waiver.

4. Amerada is a Delaware corporation engaged in the business of an integrated oil company.

5. Respondent Arthur Young is an accounting firm and was Amerada's auditor in 1972, 1973 and 1974. The documents sought by the instant summons (the "Arthur Young Summons") all relate to Amerada.

BACKGROUND

6. On February 22, 1976, during the course of its normal yearly audit by the IRS, Amerada received from the IRS Information Document Request No. 160, the subject of which was "Slush Funds Years 1972-1973". Attached to the Information Document Request was a questionnaire containing a number of questions directed to six Amerada officers and directors and requesting an oral interview with the named persons. The request was signed by William E. Huntley, the IRS Case Manager in charge of the ongoing audit of Amerada's 1972 and 1973 federal income tax returns.

7. Thereafter, on April 7, 1976, the Board of Directors of Amerada adopted a resolution establishing a Special Committee to determine whether, from January 1, 1971 through 1976, any illegal political contribution or any questionable payments to any governmental official had been made with corporate funds. Pursuant to this resolution, an extensive investigation was conducted for the Special Committee by the law firm of Milbank, Tweed, Hadley & McCloy. Arthur Young was retained to assist Milbank, Tweed with the investigation.

8. The investigation uncovered payments aggregating $7,830 in 1972, 1973 and 1974—the three years under IRS

investigation—which had apparently been made to members of a local police department. In addition, there were minor gratuities such as sheep and pen and pencil sets to foreign governmental officials—all apparently legal in the countries where they were given—and two illegal political contributions totalling $500 clearly made in error.

9. The gratuities and political contributions were accurately recorded on the Corporation's books. In view of Amerada's revenues of seven billion dollars and $57.7 million of federal income taxes paid in this three-year period, these payments can only be characterized as legally insignificant.

10. In late June, 1976, six officers and directors of Amerada and the partner of Arthur Young in charge of Amerada's audit received a letter from the IRS stating that the Corporation's income tax returns were being audited. An IRS Questionnaire commonly known as the "Eleven Questions" was enclosed with the letter. These superseded the earlier set of questions directed to the same persons.

11. Amerada officers and directors responded to the "Eleven Questions" by affidavit. The affidavits disclosed the payments uncovered by the investigation and noted that they had been deducted on Amerada's corporate income tax returns. By letter subscribed under penalties of perjury, the partner of Arthur Young in charge of Amerada's audit indicated that he had no reason to believe that the responding affidavits of the Amerada officers and directors were inaccurate.

12. The Corporation took improper deductions of less than $3,000 per year in the three years under investigation when its "other deductions" on its Federal tax returns totalled $340,000,000 and taxes paid totalled $57,000,000. Subsequently, the Corporation advised the IRS that it would concede the disallowance of the improper deductions.

13. Thereafter, Amerada received 18 IRS information document requests. All but two of these requests (asking for documentation of the payments to police) were answered fully and completely. The unanswered document requests, which would merely corroborate what the Corporation had previously disclosed to the IRS, were believed by

Amerada to be irrelevant to an examination of its tax returns. In the course of responding to other requests, Amerada cooperated consistently with the IRS and provided substantial documentation.

14. In August, 1977, after Amerada declined to provide material covered by the two document requests, the Corporation was informed that its case had been referred to the Intelligence Division of the IRS in Asbury Park, New Jersey, which had decided to undertake a criminal investigation of Amerada.

15. In September 3, 1977, other representatives of Amerada and I met with the Intelligence Division's Special Agent in charge of the case, Kenneth Kalemba, and Mr. Kalemba's supervisor, Mr. John J. Kuper, Group Manager. We were informed that Special Agent Kalemba's purpose was to conduct a criminal investigation of Amerada. We were also informed that the only basis for the criminal investigation were the payments described in paragraph 8. Moreover, we were told at that meeting that the IRS had no evidence that the disclosures of Amerada had been incomplete or inaccurate.

16. During the course of the meeting, the IRS expressed a desire to continue with the civil audit and inquired whether the Corporation had any objection to this procedure. The Amerada representatives stated that they would consider this question, but expressed concern as to how continuing document requests could be separated to distinguish between the discovery efforts of the criminal investigation and the civil audit. The Amerada attorneys at that meeting wanted to be able to know which document requests were related to the criminal investigation.

17. In response to the Corporation's expressed concern, Special Agent Kalemba agreed that if Amerada consented to the continuation of the civil audit, all document requests for purposes of the civil audit would be reviewed by him and initialed and sent by Revenue Agent Caputo (the agent who works on the civil audit) to the person at Amerada who normally received such requests, and that all requests for documents or information for purposes of the criminal in-

vestigation would come from Kalemba and be directed to an Amerada attorney.

18. Upon information and belief, within a week thereafter and in reliance upon this agreement, Special Agent Kalemba was informed by Robert G. Morvillo, Esq., an attorney for Amerada, that Amerada would consent to the continuation of the civil audit.

19. At the meeting on September 3, Special Agent Kalemba requested documents from Amerada for his criminal investigation. The representatives of Amerada told Special Agent Kalemba that they would like to consider his document requests and would give him their response shortly.

20. Upon information and belief, after discussing the matter with representatives of Amerada, Mr. Morvillo, who had also attended the September 3 meeting, called Special Agent Kalemba and told him that Amerada was concerned and puzzled by the institution of a criminal investigation where none seemed warranted by the facts, especially in view of the *de minimis* nature of the payments. Mr. Morvillo asked Special Agent Kalemba for his suggestion of a person in a position of responsibility at the IRS with whom we might raise the question whether a criminal investigation was warranted. Mr. Kalemba declined to give that information.

21. Mr. Morvillo and I then addressed a letter, a copy of which is attached as Exhibit C, to the Director, Criminal Tax Division of the IRS. After substantial delay at the IRS, the matter was eventually referred to the District Director in Newark and, with Mr. Kalemba's assistance, we sought a meeting with him.

22. On January 12, 1978—after a date had been set for our meeting with the district director but before the meeting was held—Amerada was served with two summonses ("the January 12 summonses") for the documents requested by Special Agent Kalemba at the September 3 meeting. At no time during this period of time, or even subsequently when we met with the District Director, were we advised that the information requested by Mr. Kalemba on September 3 was sought for civil purposes or to determine the cor-

rect tax liability of Amerada. According to Mr. Kalemba's explicit representation, the information was requested solely for the purpose of furthering the criminal investigation.

23. Amerada notified the IRS of its refusal to comply with the January 12, 1978 summonses on the ground, among others, they had been issued solely for a criminal purpose and thus were invalid.

24. Despite the consent of Amerada to its continuation, the civil audit was suspended during the period from the September 3 meeting through January 12, 1978 when the summonses were issued.

25. Revenue Agent Caputo testified that the civil audit remained in suspension until "[p]robably April or May." (Tr., *United States* v. *Amerada Hess Corp.*, D. N.J. Civ. No. 78-753 ("*Kalemba-Jersey I*") at 123. On April 17, 1978—while the civil audit was still suspended—Special Agent Kalemba served the instant summons on Arthur Young ("Arthur Young summons"). Pursuant to 26 U.S.C. § 7609(a), Special Agent Kalemba notified Amerada of this summons. On the following day, Special Agent Kalemba served a similar summons on N. Tannenbaum & Co., another accounting firm employed by Amerada, and similarly notified Amerada.

26. Amerada believed these summonses to be invalid since they had been issued solely for a criminal purpose—there being no active civil audit at the time. Amerada, pursuant to its statutory right, directed Arthur Young and N. Tannenbaum & Co. not to comply with these summonses. A copy of Amerada's letter, dated April 21, 1978, instructing Arthur Young not to comply with the summonses is attached as Exhibit D. A copy of this letter was also sent to the IRS.

27. On April 26, 1978, the IRS filed a petition to enforce the two January 12, 1978 summonses in the United States District Court for the District of New Jersey.

28. Shortly after the service of the Arthur Young summons and the initiation of enforcement proceedings for the January 12, 1978 summonses, the civil audit was activated. In accordance with the agreement reached on September 3, Special Agent Kalemba (and his successor to the investiga-

tion, Special Agent Armstrong) initialed all civil document requests, and Amerada complied with all such requests.

29. On May 25, 1978, the IRS served two additional summonses on Amerada with which Amerada declined to comply. On the same day the IRS served a summons on Irving Trust Co. with which Amerada instructed Irving Trust not to comply. These refusals were premised in part on Amerada's belief that the summonses were issued solely for a criminal purpose.

30. On July 18 and 20, 1978, there was an evidentiary hearing in *Kalemba-Jersey I* before the late Judge George H. Barlow of the United States District Court for the District of New Jersey. Amerada raised, among other arguments, the solely criminal purpose defense. By opinion and order dated December 8 and January 22, 1979, Judge Barlow rejected the solely criminal purpose defense and enforced the January 12, 1978 summonses. In essence, Judge Barlow ruled, as a matter of law, that as long as the civil audit had not been completed, the summonses would be deemed to have been issued for a legitimate civil purpose. Because of the legal standard which he applied, Judge Barlow made no factual finding with respect to the September 3 agreement by the IRS to distinguish between, and separately label, civil and criminal document requests. As noted in the accompanying memorandum of law (at 10n.), Amerada contends that Judge Barlow erred in reaching this conclusion.

31. Judge Barlow stayed his order pending appeal. An appeal in that case was argued before the United States Court of Appeals for the Third Circuit on October 19, 1979.

32. Prior to filing the petition to enforce the Arthur Young summons, the IRS initiated three other enforcement proceedings in connection with the Amerada investigation. In two of these cases (involving the N. Tannenbaum & Co. and Irving Trust Co. summonses) Amerada consented to production.

33. In the third case brought with respect to the Amerada summonses issued on May 25, 1978 (see ¶ 29, *supra*), Amerada opposed enforcement based upon the solely criminal purpose defense as well as other defenses. *United*

States of America v. *Amerada Hess Corp.*, D. N.J. Civ. No. 79-1805 ("*Armstrong-Jersey II*"). In that case, United States District Judge Clarkson S. Fisher, without a hearing, enforced the two summonses, but recognizing the identity of issues between that litigation and the appeal pending in the Third Circuit, stayed the execution of his order pending decision by the Third Circuit, and gave Amerada permission to relitigate after the Third Circuit's decision.

AFFIRMATIVE DEFENSES

Solely Criminal Purpose

34. The preceding history of the IRS investigation of Amerada indicates conclusively that the sole purpose underlying the issuance of the Arthur Young summons was to gather evidence as part of a criminal investigation of Amerada. At the September 3, 1977 meeting between IRS and Amerada, Special Agent Kalemba in the presence of his superior, Special Agent Kuper, agreed to define the IRS requests as either civil or criminal. There can be no dispute about this fact since Special Agent Kalemba admitted it in the hearing before Judge Barlow. A copy of page 44 of the hearing transcript containing Special Agent Kalemba's testimony is attached as Exhibit E.

35. Further testimony at the hearing disclosed that Group Manager, John Kuper, Special Agent Kalemba's immediate supervisor, approved the issuance of the January 12, 1978 summonses against Amerada with full knowledge of the agreement to distinguish between civil and criminal document requests; that Kalemba's request for authority to issue those summonses was forwarded to Kalemba's Branch Chief, Mr. Rubin, and then to the chief of the Intelligence Division, Mr. McElroy, who approved the request and transmitted it to regional counsel; and that in connection with the summonses, there were discussions between Special Agent Kalemba and Alice Holecheck, a representative of regional counsel. I have no reason to believe that the IRS institutional procedure for obtaining authority to issue the Arthur Young summons was materially different from that followed with regard to the January 12, 1978 summonses addressed to Amerada.

36. In view of this testimony and the fact that the IRS has complied with this agreement to distinguish between civil requests and criminal summonses (see paragraph 17, *supra*), the IRS should not now be heard to argue that the Arthur Young summons was issued for any civil purpose.

37. As noted above, on Revenue Agent Caputo's own testimony (see ¶ 25, *supra*), at the time of the issuance of the Arthur Young summons by Special Agent Kalemba, the civil audit was suspended.

38. Upon information and belief, Amerada understands that the civil audit for 1972 and 1973 has been virtually completed.

Arthur Young's tax accrual workpapers are not subject to discovery by the IRS

39. Paragraph 13 of the summons calls for information in the tax accrual file. The IRS knows that this information is extremely sensitive to all corporations since it discloses the corporation's views with respect to tax issues presently at issue between it and the Service. For the IRS to take possession of this type of information would be similar to an attorney's attempt to learn his opponent's trial strategy and methods of preparation for the conduct of the case.

40. Upon information and belief, never in Amerada's history has the IRS sought this information. Although the civil audit had been initiated some two years before the issuance of the Arthur Young summons, this type of information was never sought either formally or informally.

41. Upon information and belief, the IRS has rarely asked for tax accrual files from any corporation. Yet, without warning of any kind, Special Agent Kalemba summoned them in an investigation having nothing to do with tax accrual. The Kalemba investigation dealt exclusively with Amerada's disclosures in the questionable payment area. Despite the suggestion in the summons that this file might contain reserves for bribes, I am informed by Mr. Bruce M. Greenwald, the Arthur Young partner with responsibility for Arthur Young's tax work for Amerada, that the tax accrual file contains no information even remotely relevant to

questionable payments. Affidavit of Bruce M. Greenwald, sworn to on December 26, 1979, ¶ 3.

The Arthur Young summons was issued to harass the taxpayer and is unduly broad and burdensome.

42. I have been informed by Carl D. Liggio, Esq., general counsel for Arthur Young, that the instant summons calls for the production of virtually every piece of paper in the Arthur Young files relating to Amerada. Mr. Liggio estimates that there are in excess of 250,000 pages of documents called for by the summons. Affidavit of Carl D. Liggio, Esq. ("Liggio Aff."), sworn to December 28, 1979, ¶ 3. Arthur Young's tax accrual workpapers are not subject to discovery by the IRS.

43. This unprecedented summons issued only after the Amerada refused to comply with Special Agent Kalemba's first two criminal summonses.

44. Thus, it can only be concluded that Special Agent Kalemba apparently issued this summons to punish and harass Amerada because the company would not cooperate with his investigation.

45. At the very least, it is clear that the great majority of the documents sought, including the tax accrual file, are irrelevant to any continuing civil or ciminal investigation.

Attorney's Work Product

46. As noted above, the instant investigation is predicated upon Amerada disclosures after its internal questionable payments review.

47. By March of 1976, there had been public announcements of six settlements of Securities Exchange Commision ("SEC") enforcement actions against corporations charging them with violations of the federal securities laws by reason of their failure to accurately reflect on their books and records, certain illegal or "sensitive" payments and to disclose those payments in reports filed with the SEC. Three oil companies were included in that group of six. In addition, the SEC had reported the filing of seven other cases relating to the same types of allegedly illegal activities. At

least one private shareholders' action had been commenced as a result of the foregoing SEC actions.

48. Although I had no reason to believe that Amerada had engaged in similar activities, it was a corporation with international activities in areas which had different standards for doing business than those of the United States. I, therefore, believed that an investigation and litigation might be commenced by the SEC against Amerada to determine whether it had engaged in any similar activities involving improper payments. I therefore advised the Corporation that it should authorize a Special Committee to review the Corporation's activities in this area.

49. On April 7, 1976, the Board of Directors of Amerada adopted a resolution establishing a Special Committee to determine whether any illegal political contributions or questionable payments to government officials had been made with corporate funds. The Special Committee was directed to proceed in its investigation with the professional assistance of Milbank, Tweed, Hadley & McCloy in order that the Board of Directors could be best advised as to the legal implications of the facts unearthed by the investigation.

50. Having in mind the applicable statutes and the SEC's disclosure policy with regard to questionable payments and its increasingly active enforcement policy as set forth in the SEC's report dated May 12, 1976, which was submitted to the Senate Banking Housing and Urban Affairs Committee, Milbank, Tweed, Hadley & McCloy conducted the investigation on behalf of the Special Committee.

51. In order to conduct the investigation, Amerada retained Arthur Young to assist Milbank, Tweed. The Arthur Young Special Committee workpapers file, which is the target of paragraph 14 of the Arthur Young summons, was prepared at the request of Milbank, Tweed in connection with the investigation. (See Liggio Aff., ¶ 7).

52. Upon completion of the investigation, Milbank, Tweed, Hadley & McCloy submitted to the Special Committee "Counsel's Memorandum to Amerada Hess' Special Committee" which contained the results of Milbank's factu-

al and legal research, its analysis and its advice to the Special Committee.

53. In the *New Jersey-Kalemba I* summons enforcement proceeding, Judge Barlow found that Amerada's Special Committee was formed, and its investigation was conducted, in anticipation of litigation. The IRS had never disputed or appealed from this finding, and both parties are bound by virtue of the doctrine of collateral estoppel. Clearly, the Arthur Young Special Committee workpapers file is covered by the attorney work product doctrine.

54. Amerada furnished the IRS with the Special Committee's Report to the Amerada Board of Directors and the analyses of the special disbursing account which reflects the product of Arthur Young's and Milbank, Tweed's investigation. These documents contain the factual data relating to alleged questionable payments in which the IRS is apparently interested. The IRS has also received many documents from Irving Trust Co. and N. Tannenbaum & Co., including the checks and records of the special disbursing account through which Amerada makes payments to consultants. (see ¶ 25 supra).

55. Upon information and belief, Amerada's books of account and financial and transactional records have been made available to the IRS in connection with its regular examination for the years 1972 and 1973, and will be made available to complete the regular examination for 1974. Accordingly, the IRS has access to all corporate records on which Arthur Young based its opinions and analysis of the Special Committee workpapers, as well as its opinions, judgments and thoughts regarding the adequacy of the tax liability account contained in the tax accrual workpapers.

56. The IRS should not be permitted to take advantage of attorney's work product rather than conduct its own investigation.

* * *

57. Based upon the foregoing and the authorities discussed in the accompanying memorandum of law of Amerada, as well as the affidavit of Carl D. Liggio, Esq. and the Arthur Young memorandum of law, to which this Court is respectfully referred, it is requested that the IRS petition

for enforcement should be dismissed or, in the alternative, that an evidentiary hearing should be held.

/s/ ROGER B. ORESMAN
ROGER B. ORESMAN

Sworn to before me this 28th day of December, 1979

/s/ JOHN C. MALONEY, JR.
JOHN C. MALONEY, JR.
Notary Public

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

M 18-304

UNITED STATES OF AMERICA, PETITIONER,

v.

ARTHUR YOUNG & COMPANY, RESPONDENT,

and

AMERADA HESS CORPORATION, RESPONDENT INTERVENOR.

AFFIDAVIT

STATE OF NEW YORK)
COUNTY OF NEW YORK : ss.:
SOUTHERN DISTRICT OF NEW YORK)

KATHERINE J. TRAGER, being duly sworn, deposes and says:

1. I am a Special Assistant United States Attorney in the office of Robert B. Fiske, Jr., United States Attorney for the Southern District of New York and have been assigned to represent the interests of the United States in this action. I submit this affidavit in response to the opposing affidavits of intervenor Amerada Hess Corporation ("Hess") and respondent Arthur Young & Co. ("Arthur Young").

2. As set forth in the affidavits of Special Agents Robert G. Armstrong and Kenneth J. Kalemba submitted in support of the Petition, the summons was issued to Arthur Young in connection with a joint investigation of Hess by the IRS's Examination and Criminal Investigation Divisions. This summmons was one of seven issued so far in the course of the investigation. Four summons were issued to Hess, and one each to Irving Trust Company, Hess's bank, and to N. Tannenbaum & Company, and Arthur Young, Hess's accountants.

3. Hess refused to produce any of the information or documents requested in its summonses and instructed Irving Trust, Arthur Young and Tannenbaum not to comply with the summonses served upon them.

4. As a result, the United States has instituted five proceedings to enforce the summonses. The first proceeding United States of America v. Amerada He . 79-1137 (DNJ) ("*Hess I*") sought to enforce two of the Hess summonses which requested specific information and documents about questionable domestic and foreign payments by Hess. Judge Barlow of the District Court of New Jersey ordered enforcement of the summonses on January 22, 1979. (A copy of Judge Barlow's opinion in *Hess I* is attached as Exhibit A). Hess has appealed this order to the Third Circuit.

5. On December 6, 1978, the United States commenced a proceeding in this Court to enforce the summons served upon Irving Trust. (A copy of the petition is attached as Exhibit B.) After counsel for Hess had the opportunity to inspect Irving Trust's documents, Hess withdrew its direction to Irving Trust not to comply with the summons. (Exhibit C).

6. On June 8, 1979, the United States commenced a second enforcement proceeding in the Southern District, this time to enforce the summons issued to Tannenbaum. Again, after Hess examined the Tannenbaum documents, it withdrew its direction to Tannenbaum not to comply with the summons. Thereafter, Hess made an application to intervene and for modification of the order solely to provide that the case be marked closed. (Exhibit D). Judge Sand denied this motion by order dated August 28, 1979. (Exhibit E).

7. Subsequently, the United States commenced a second proceeding against Hess in *United States* v. *Amerada Hess*, 79-1805. The District Court of New Jersey ordered enforcement of this summons on November 16, 1979. (Exhibit F).

8. In connection with this proceeding, I had discussions with Carl Liggio, General Counsel for Arthur Young. Mr. Liggio requested that I request the IRS agents to further specify the documents sought. After consultation with Special Agent Armstrong, I informed Mr. Liggio that at this

stage of the investigation the agents did not have sufficient information to further specify the documents summoned.

/s/ KATHERINE J. TRAGER
KATHERINE J. TRAGER

Sworn to before me this 7th day of January, 1980.

/s/ NANCY E. FRIEDMAN
NANCY E. FRIEDMAN
Notary Public, State of New York

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

M-18-304

UNITED STATES OF AMERICA, PETITIONER,

v.

ARTHUR YOUNG & COMPANY, RESPONDENT,

and

AMERADA HESS CORPORATION, RESPONDENT-INTERVENOR.

SUPPLEMENTAL AFFIDAVIT

STATE OF NEW YORK)
: ss:
COUNTY OF NEW YORK)

G. ROBERT ARMSTRONG, being duly sworn deposes and says:

1. I submit this supplemental affidavit in response to the affidavits submitted on behalf of respondent Arthur Young & Company and taxpayer-intervenor Amerada Hess Corporation ("Hess").

2. In my capacity as a Special Agent, I together with Revenue Agent Anthony Caputo of the Examination Division, am continuing an investigation of Hess, one purpose of which is to ascertain the correctness of Hess's tax returns for the years 1972, 1973 and 1974. As a result of Hess's resistance to all IRS summonses, the investigation has been stymied. The investigation is continuing, and I have not yet made, and am not yet in a position to make, any recommendation one way or the other to my supervisor pending further investigation.

/s/ G. ROBERT ARMSTRONG
G. ROBERT ARMSTRONG

Sworn to before me this 4th day of January 1980.

LYNWOOD HAYES
Notary Public

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

M-18-304

UNITED STATES OF AMERICA, PETITIONER,

v.

ARTHUR YOUNG & COMPANY, RESPONDENT,

and

AMERADA HESS CORPORATION, RESPONDENT-INTERVENOR.

AFFIDAVIT

STATE OF NEW YORK)
COUNTY OF NEW YORK : ss.:
SOUTHERN DISTRICT OF NEW YORK)

KENNETH J. KALEMBA, being duly sworn, deposes and says:

1. I am employed as a Special Agent in the Office of the District Director of Internal Revenue, Newark District, with a post of duty at Asbury Park, New Jersey.

2. In my capacity as a Special Agent, I together with Revenue Agent Anthony Caputo of the Examination Division, was conducting an investigation of Amerada Hess Corporation ("Hess") a purpose of which was to ascertain the correctness of Hess's tax returns for the years 1972, 1973 and 1974. I left the investigation in May 1978.

3. The Hess investigation is a joint investigation conducted by the Examination and Criminal Investigation Divisions. At the time I left the investigation, Special Agent Armstrong assumed my responsibilities and I am informed that the investigation is continuing. As of the time I left the investigation, no recommendation for criminal prosecution has been made by the Internal Revenue Service to the Department of Justice with respect to the matters under investigation. Indeed, while I was assigned to the matter, I was never in a position to make any recommendation one

way or the other to my supervisor pending further investigation.

4. While I was in charge of the investigation, and with the approval of my Group Manager, I issued an Internal Revenue Service summons directing the respondent to appear before me to testify and produce for examination the books, records and other documents described in the summons, a copy of which is annexed to the Petition as Exhibit B.

5. Thereafter, the summons was personally served on respondent at the time and in the manner indicated by Exhibit B at page 2.

6. In accordance with Section 7609(a) of the Internal Revenue Code of 1954, as amended, notice of service of the summons and copies of the summons was sent by certified or registered mail to the taxpayer in the manner indicated by Exhibit B at page 2.

7. Subsequently, the taxpayer instructed respondent not to comply with the summons. A copy of those instructions is annexed to the Petition as Exhibit C.

8. The respondent objected to the summons and said it would not comply with the summons. I am informed that the refusal to comply with the summons continues to the date of this affidavit.

9. To my knowledge, the books, records or other data sought by the summons are not and have never been in the possession of the Internal Revenue Service.

10. It is necessary to examine the books, records and other papers demanded by the summons and to take the testimony of respondent in order to ascertain the correctness of the tax returns filed by the taxpayer for the years under investigation.

/S/ KENNETH J. KALEMBA
KENNETH J. KALEMBA

Sworn to before me this 4th day of January 1980.

/S/ LYNWOOD HAYES
LYNWOOD HAYES
Notary Public

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

M-18-304

UNITED STATES OF AMERICA, PETITIONER,

v.

ARTHUR YOUNG & COMPANY, RESPONDENT

and

AMERADA HESS CORPORATION, RESPONDENT-INTERVENOR.

AFFIDAVIT

STATE OF NEW YORK)
COUNTY OF NEW YORK : ss:
SOUTHERN DISTRICT OF NEW YORK)

ANTHONY CAPUTO, being duly sworn, deposes and says:

1. I am employed as a Revenue Agent in the office of the District Director of the Internal Revenue Service ("IRS"), Newark District, with a post of duty at Mountainside, New Jersey.

2. In my capacity as an IRS Revenue Agent, I am conducting a joint investigation with Special Agent G. Robert Armstrong, a purpose of which is to ascertain the correctness of the tax returns filed by the Amerada Hess Corporation ("Hess") for the tax years 1972, 1973 and 1974. The investigation is continuing.

3. The testimony, books, records and other papers described in the summons annexed to the Petition as Exhibit B are not currently in the custody, possession or control of the IRS and it is necessary to examine such material in order to ascertain the correctness of the 1972, 1973 and 1974 returns of the taxpayer.

4. To my knowledge, no recommendation of any criminal prosecution in this case has been made to the Department of Justice by the IRS.

/s/ ANTHONY CAPUTO
ANTHONY CAPUTO

Sworn to before me this 4th day of January 1980.

LYNWOOD HAYES
Notary Public

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

M-18-304

UNITED STATES OF AMERICA, PETITIONER,

v.

ARTHUR YOUNG & COMPANY, RESPONDENT

and

AMERADA HESS CORPORATION, RESPONDENT-INTERVENOR.

AFFIDAVIT

STATE OF NEW YORK)
COUNTY OF NEW YORK : ss.:
SOUTHERN DISTRICT OF NEW YORK)

ROBERT G. MORVILLO, being duly sworn, deposes and says:

1. I am the attorney for the respondent-intervenor Amerada Hess Corporation. As such, I am familiar with the facts set forth herein. This affidavit is submitted in response to the affidavit of Katherine J. Trager, which affidavit was submitted in opposition to the motion of both respondents to stay the instant case or in the alternative to transfer the case to the United States District Court for the District of New Jersey.

2. The Trager affidavit opposes a stay on the grounds that 1) other enforcement proceedings in this case have been initiated in the Southern District of New York and 2) that the defenses interposed by Amerada Hess Corp. to the instant summons enforcement proceedings are not similar to the defense, presently before the Third Circuit. Both of these contentions are without merit.

3. It is simply irrelevant that two other summons enforcement cases (the Irving Trust case and the Tannenbaum case) were initiated in the Southern District of New York without Amerada Hess moving for a stay. There was

no reason in either of those cases to move for a stay since Amerada Hess Corp. made the decision to avoid the litigation by consenting to the documents being turned over. Consequently, Amerada Hess Corp. chose not to interpose any defenses to those summonses and there was, therefore, no reason to seek a stay.

4. The Government's contention that the case pending before the Third Circuit is not relevant to this proceeding is factually incorrect. While it is true that there are other defenses interposed to this proceeding that were not raised in the New Jersey litigation, it is clear from our original affidavits, submitted in support of this motion, that the identical defense of sole criminal purpose is raised here as it was in New Jersey. It is also clear beyond doubt that any decision by the Third Circuit with regard to the validity of this defense will impact upon the instant litigation. Indeed, the Third Circuit decision could well be totally dispositive and obviate the necessity of litigating this issue in any way.

5. Thus, the Government has advanced no good reason why the stay in this matter should not be granted. As noted in our original moving papers, this summons is 17 months old. To defer decision on its validity for several more weeks before the Third Circuit renders its decision is both economical and fair.

WHEREFORE, it is respectfully requested that the motion of respondents for a stay pending a decision of the Court of Appeals for the Third Circuit in *United States* v. *Amerada Hess Corp.*, Docket No. 79-1317 (3rd Cir. 1979) be granted and in the alternative that the motion of the respondents to transfer venue to the United States Court for the District of New Jersey be granted.

/S/ ROBERT G. MORVILLO
ROBERT G. MORVILLO

Sworn to before me this 17th day of December, 1979

/S/ KATHERINE HOR
KATHERINE HOR
Notary Public

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

M-18-304

UNITED STATES OF AMERICA, PETITIONER,

v.

ARTHUR YOUNG & COMPANY, RESPONDENT,

and

AMERADA HESS CORPORATION, RESPONDENT-INTERVENOR.

AFFIDAVIT IN RESPONSE TO GOVERNMENTS MEMORANDUM OF LAW

STATE OF NEW YORK)
COUNTY OF NEW YORK : ss.:
SOUTHERN DISTRICT OF NEW YORK)

ROBERT G. MORVILLO, being duly sworn, deposes and says:

1. I am an attorney representing respondent-intervenor Amerada Hess Corporation ("Amerada") in the above-captioned case. As such, I am familiar with the facts set forth herein.

2. This affidavit is submitted on behalf of both respondents in response to the Government's memorandum of law and supplemental affidavits.

3. In an attempt to deflect the Court's attention from the serious defects of the instant summons, the Government in its papers has distorted the record to make it appear that Amerada has stonewalled all efforts of the Government to get access to its documents. These same assertions were repeated by the Government on oral argument.

4. These insinuations are totally inaccurate. Upon information and belief, since the inception of the civil audit of Amerada by the IRS in 1975, Amerada has received in excess of 325 civil document requests and to date has provided the documents sought in response to all but 11 of these

requests. Conservatively, Amerada estimates that the IRS has had access to or has received in excess of 40,000 pages of documents in response to these requests. The latest such request made by the Government was received on December 4, 1979 and the Company has supplied data as recently as January 3, 1980. Of the 11 outstanding requests, the Company is in the process of gathering the documents. In addition, the Amerada tax department has supplied oral answers to many IRS civil audit questions. Amerada estimates that between 1975 and 1979, some 11,500 man hours of Amerada personnel time have been expended on this audit. The oral and written requests have covered the entire gamut of the Amerada audit and include varied requests for such items as contracts for joint ventures with other oil companies, investment credit documents, leasing documents, minutes of Board of Directors meetings, 1099 forms, and consulting agreements. Moreover, as originally noted in paragraph 13 of the Oresman affidavit filed in opposition to the enforcement petition, an additional 18 document requests were given to Amerada relating directly to the so-called questionable payments. These requests asked for detailed information such as the names of the recipients of the sheep Amerada gave as gifts, documents relating to the disclosed $500 political campaign contribution and information relating to a used trailor sold to the St. Croix Police Department. All but two of these requests were answered. (Samples of document requests are annexed hereto as Exhibit A.)*

5. In addition, upon information and belief, Amerada has consented to N. Tannenbaum & Co. turning over approximately 5,000 pages of documents to the IRS and Irving Trust Co. turning over 1,500 documents to the IRS.

6. Finally, although Amerada has contested several of the summonses issued by the IRS in conjunction with its criminal investigation, Amerada has on several occasions offered to supply to the IRS many of the documents called

* It should be noted that in conjunction with the September 3, 1977 labelling agreement between the IRS and Amerada, this exhibit verifies that document requests issued before September 3, 1977 do not bear the initials of a Special Agent but those issued thereafter do.

for in all of the summonses in an effort to prevent litigation. In each instance, the IRS has flatly rejected any compromise short of total compliance with each and every item called for in all summonses.

7. Thus, it is both unfair and inaccurate to depict Amerada as being defiant (Reply Memorandum of Law in Support of Petition to Enforce an Internal Revenue Service Summons, hereinafter "Reply Memo", p. 46) or as having frustrated a "vital public interest" (Reply Memo, p. 45).

8. As noted above, the tactical decision to attack Amerada has undoubtedly been motivated by the inability of the Government to demonstrate the relevance of any of the documents requested in the instant summons. At oral argument, the Government conceded that it could not establish relevance until it actually examined the documents sought nor would it more precisely define the documents sought.

9. This assertion is difficult to comprehend when viewed in the context that since 1975 IRS has received in excess of 45,000 pages of documents relating to Amerada's tax return.

10. The inability of the IRS to define the relevance of the documents and its refusal to designate with more specificity the documents needed undoubtedly stems from the fiction which it has attempted to maintain herein that the summons seeks documents needed to ascertain the correctness of the Amerada tax returns. Surely after four years of access to the 45,000 pages of documents underlying these tax returns, the IRS should be able to point to their remaining specific questions or problems and articulate how the requested documents relate to such. Thus, the IRS posture as contained in its supplemental papers and the oral argument of carefully evading relevance, demonstrates that, in fact, these documents are being sought solely to further the criminal questionable payments investigation. As noted in our prior papers this constitutes an improper use of a summons.

11. As also noted in our prior affidavits, this precise legal issue with no substantial factual variation is presently before the United States Court of Appeals for the Third Circuit.

12. The Government's treatment of the appeal before the Third Circuit is extremely perplexing. In its opposition to respondents' motion for a stay premised upon the contention that a decision by the Third Circuit on the issue of sole criminal purpose would be binding in this case, the Government stated:

> "This proceeding simply does not involve 'the precise factual and legal issues' pending before the Third Circuit." (Trager Aff. dated December 17, 1979 filed in opposition to motion for stay, ¶ 8).

Several weeks later, the Government apparently changed its mind as to the identity of issues between this litigation and that pending before the Third Circuit. Now, the Government contends that respondents are collaterally estopped from litigating the sole criminal purpose defense in this District because of the findings of the District Court in the case before the Third Circuit (Reply Memo, pp. 15-19).

13. We submit that this attempt to have it both ways is, at the least, inappropriate. It is clear that the Third Circuit's decision will most probably bind both Amerada and the IRS on the sole criminal purpose defense and its outcome should be awaited if this Court decides to rule on the merits of this defense.

14. We believe, however, that it is unnecessary for the Court to reach the merits of the sole criminal purpose defense and reiterate that the Court should deny enforcement of the instant summons based upon the Government's failure to particularize the documents needed and to demonstrate relevance of any of the categories of documents called for in the summons.

15. It should also be noted that the Government's Reply Memo is replete with misstatements of fact and law.

For instance, the intimations contained in the footnotes on pages 15, 19 and 22, the suggestion that somehow the Couch case overrules the Harrington standard on p. 37 and the discussion of work product on p. 45, are all plainly erroneous. To refute each misstatement or miscitation would double the length of these papers without in any way further clarifying the issues. Suffice it to say that our failure to address each such error should in no way be construed as

an agreement with the Government's factual or legal assertions.

WHEREFORE, it is respectfully requested that the Court enter an order dismissing the petition.

/s/ ROBERT G. MORVILLO
ROBERT G. MORVILLO

Sworn to before me this 11th day of January, 1980.

/s/ KATHERINE HOR

Informal Document Request

Request No. 13

To (Name of Taxpayer and Company Division or Branch)
Emerald Electric, Inc. Canada

Subject Year: 1972 - 1973
Subj: Retained Earnings

Dates of Previous Requests

Description of Documents Requested

Year: 1972

1. Please provide supporting details for the following prior period adjustment to retained earnings - unappropriated in the year 1972:
Prior Period Adjustment - - - 1,792,081

Year: 1973

2. Provide supporting details for the following adjustments to retained earnings - unappropriated entitled "Transfer upon merger of subsidiaries and/or transfer of retained earnings" - - - $1,160,000

FROM

Name and Title of Requester
William E. Hendley, Case Mgr.

Date
10-21-75

Office Location
Washington, D.C.

Form 4564 (Rev. 1-74)

Part 1 - TAXPAYER'S FILE COPY

Informal Document Request

(5)

164

To (Name of Taxpayer and Company (Use name on Return))
Amerada Hess Corp.
R & M. Partners

Taxable year - 1972 - 1973
Amortization of Deferred Charges - Goodwill

Date of Document Request:

Description of Document Requested

1. Analysis of account 19-577
(Deferred Chgs. Amortization of Goodwill.)
indicates that you are amortizing goodwill.
Please provide the following.
(a) Name of companies involved
(b) Verification that the amount being amortized is not goodwill
(c) Nature of the item being amortized
(d) Verification of the basis by each Company
(e) Period of time the amount is being amortized over.
(f) Receivable amounts from the time of acquisition of the companies involved to the amount shown on General Ledger account # 19-577 as of 1-1-72, $ 510,330.99.

FROM

Name and Title of Requestor
Wm. E. Hartley, Case Mgr.

Office Location
Washington, D.C.

Date
3-23-76

4564 (Rev. 7-70)

Part 1 - TAXPAYER'S FILE COPY

Form 4564
Information Document Request

Request No. 1

To: (Name of Taxpayer and Company Division or Branch)
Amerada Hess Corporation and Subs.

Subject Year: 1974
Books & Records

Please return part II with listed documents to requester identified below.

Dates of Previous Requests

Description of Documents Requested

1. Please provide workpapers including balance sheet items, profit + loss items and Schedule M-1 adjustments for the following entities for the year 1974.

(a) Amerada Hess Corp.:
1. ~~E + P Tulsa Division~~
2. Corporate Headquarters Div.
3. R + M Division

(b) ~~Amerada Hess Corp of Abu Dhabi~~

(c) Amerada Hess Corp. of Iran /

(d) ~~Amerada Hess Corp of Peru~~ /

(e) Amerada Hess Corp. of Bermuda. /

(f) Amerada Minerals Corp. of Canada

(g) Amerada Petroleum Corp. of Norway /

(h) ~~Amerada Petroleum Corp of U.K.~~

(i) ~~Amerada Hess Mississippi Corp~~

(j) ~~Amerada Hess Export Company~~

(k) ~~Amerada Petroleum Corp. of Libya~~

FROM
Name and Title of Requester: William E. Hewlett Case Mgr.
Office Location: Mountainside, NJ

Date: 4-6-77

Form 4564 (Rev. 11-74) /

PART 1 TAXPAYER'S FILE COPY

Information Document Request

Request No. 37

To: (Name of Taxpayer and Com... Division or Branch)
Amerada Hess Corporation
"A" Division

Subject
1974
Schedule M-1 adjustments

Dates of Previous Requests

Description of Documents Requested

1. Please provide details for the following schedule M-1 adjustments:

(a) Adjustment #1

Catalyst expense - C.D.I. refinery 4p. 17,727

Accrued catalyst expense 17,727

Decrease in refinery reserve

Balance	A. Reading	Perma	Total (a/c 23-202)
1-1-74	115,107	61,671	176,678
12-31-74	99,662	59,389	158,951
	15,445	2,282	17,727

(b) Adjustment #2

Turnaround expense - C & S. refinery 4p. 2,800,155

Accrued Turnaround expense 2,800,155

Decrease in refinery reserve

Balance	A. Reading	Perma	Total (a/c 23-201)
1-1-74	4,907,125	1,707,883	6,615,008
12-31-74	2,144,905	1,669,748	3,814,853
	2,762,220	37,935	2,800,155

(c) adjustment #3

Insurance expense - other deductions 1,000,000

Reserve for self insurance 1,000,000

Decrease in reserve for self insurance Reserve for Rig Reserve for Total

Balance	A/c 27101	A/c 27101	A/c 27101	A/c 27101	
1-1-74	1,000,000	750,000	200,000	1,000,000	2,950,000
12-31-74	—	750,000	200,000	1,000,000	1,950,000
	1,000,000	—	—	—	1,000,000

KJK

FROM

Name and Title of Requester: Wm. E. Hunter, Jr., Case Mgr. : AC

Office Location: Morristown, N.J.

Date: 5-17-78

Form 4564 (Rev. 1-74)

PART 1 - TAXPAYER'S FILE COPY

437

Form 4564
(Rev. 1-78)

Department of the Treasury — Internal Revenue Service

Information Document Request

Request No. 43

To: (Name of Taxpayer and Company Division or Branch)
Guarantee Trust Corporation

Please return part 2 with listed documents to requester identified below

Subject: Form 1099 Year 1974

Dates of Previous Requests:

Description of Documents Requested

1. Provide Form 1099 for the following individuals:

Payee	Amount	Date Check Issued	Check No.
Mr. Jack Fisher Jr.	2,500	7/5/00	11-7777
Mrs. Arthur Frost	10,000		17-3-71
Mrs. Larry Robertson	2,000		10-14-1[illegible]
Mr. Charles D. Hartley	5,000		10-9617
Mr. E. Messer	5,000		09-02[illegible]6
Mr. T. Bradley	3,000		09-0273
Mrs. Arthur J. Watson	1,100		09-02[illegible]0
Jean Watkins	10,000		09-02[illegible]7
Mrs. T. E. Brown	7,000		09-02[illegible]4
Mrs. Billy Lee	5,000		09-[illegible]612
Mrs. John Thompson	4,000		09-1400
Mr. G. H. La Croix	2,500		09-6991
Mrs. Delmar Oppenfeldt	2,000		09-6872
Mr. F. La Rue	2,500		09-67[illegible]
Mrs. Brooks Brandon	2,500		09-[illegible]

FROM

Name and Title of Requester: T. G. Crosta, Team Coordinator

Date: 7-17-79

Office Location: Atlanta, Ga.

Form 4564 (Rev. 1-78)

Part 1 - TAXPAYER'S FILE COPY

PLF/DEFT EX 1 — FF
9-11-1979 PC

Form 4564
(Rev. Feb. 1978)

Department of the Treasury — Internal Revenue Service

E. Caballero

Information Document Request

Request No. 1.1

To: (Name of Taxpayer and Company Division or Branch)
Louisiana Land Exploration

Please return part 2 with listed documents to requester identified below

Subject
Intangible Drilling Costs

Dates of Previous Requests

Description of Documents Requested

1. An analysis of IDC regarding Louisiana Federal Offshore as shown below. For the leases indicated, provide details whether the wells included were drilled for exploratory purposes primarily for offset purposes + geophysical information and whether they are drilled from mobile rig. In other words, are these wells exploratory wells. Provide AFE's for these wells.

For any well drilled for the production of oil + gas, provide AFE's and documentary evidence that they were so drilled.

Lease No.	State	RoA	Description of Property	IDC Claimed
4944	Louisiana Offshore	A31	W. Cameron Blk. 606 OCS-G-2232	$ 109,564
4944	"	A31	W. Cameron Blk. 621 OCS-G-2235	253,906
5065	"	A31	Eugene Island Blk. 57	1,015,167
5068	"	A31	Vermilion 5 Blk. 331 OCS-G-2572	713,142
5098	"	A31	Main Pass Blk. 1 OCS-G-2584	121,118
5133	"	A31	Vermilion Blk. 339-340	346,192

FROM

Name and Title of Requester
G. J. Caputo, Asst. Controller

Office Location
Metairie, La.

Date
9-5-79

Form 4564 (Rev. 2-78)

Part 1 - TAXPAYER'S FILE COPY

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

M--18-304

UNITED STATES OF AMERICA, PETITIONER,

v.

ARTHUR YOUNG & COMPANY, RESPONDENT,

and

AMERADA HESS CORPORATION, RESPONDENT INTERVENOR.

REBUTTAL AFFIDAVIT

STATE OF NEW YORK)
COUNTY OF NEW YORK : ss.:
SOUTHERN DISTRICT OF NEW YORK)

Katherine J. Trager, being duly sworn, deposes and says:

1. I submit this rebuttal affidavit in response to the affidavit of Robert G. Morvillo, counsel for taxpayer-intervenor Amerada Hess Corporation and in further support of the petition of the United States to enforce the IRS summons served upon respondent Arthur Young & Co.

2. In his affidavit Mr. Morvillo states that the IRS has "flatly rejected any compromise short of total compliance with each and every item called for in all summonses." This is not a fair statement of the Service's position; to the contrary, Hess refused to turn over any and all documents sought in the summons when the Service stated it would not consent to withdraw certain items.

3. The Government's position with respect to its collateral estoppel defense has been consistent. As the government argued in connection with the transfer motion, the legal defense *common* to both actions was Hess's criminal purpose defense. (See ¶ 9 of the Trager affidavit submitted in opposition to the transfer motion).

4. The relevance of the materials sought is fully explained in the affidavits of G. Robert Armstrong and Harry Reiter and the Government's Reply Memorandum of Law.

/s/ KATHERINE J. TRAGER
KATHERINE J. TRAGER

Sworn to before me this 15th day of January, 1980

/s/ LYNWOOD HAYES
LYNWOOD HAYES
Notary Public

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

M-18-304

UNITED STATES OF AMERICA, PETITIONER,

v.

ARTHUR YOUNG & COMPANY, RESPONDENT

and

AMERADA HESS CORPORATION, RESPONDENT INTERVENOR.

AFFIDAVIT

STATE OF NEW YORK)
COUNTY OF NEW YORK : ss.:
SOUTHERN DISTRICT OF NEW YORK)

HARRY REITER, being duly sworn deposes and says:

1. I am employed as a Case Manager in the office of the District Director of Internal Revenue, New York District with a post of duty at 120 Church Street, New York, New York. I have worked with the Internal Revenue Service since November 1945 and I am a certified public accountant. I submit this affidavit in support of the United States petition to enforce the IRS summons served upon Arthur Young & Co.

2. In my thirty-four years with the Service, including thirteen years as a Team Coordinator and Case Manager, I have had extensive experience conducting audits of large corporations. I am fully familiar with accounting practices, the functions of an audit, and the material prepared by accountants in the course of an audit.

3. I have reviewed the affidavit submitted by G. Robert Armstrong in support of this proceeding to enforce summons issued by the Internal Revenue Service. The items sought in this summons are clearly relevant to this proceeding because they would assist the Service in determining the correct taxable income and income tax liabilities for

Amerada Hess during the years under investigation. A brief explanation of the relevance of some of the accounting documents follows. The relevance of the other accounting materials sought is fully explained in Special Agent Armstrong's affidavit. The remaining items, numbered 14 through 17, pertain to specific factors involved in the investigation.

4. With respect to item 1 of the summons, the Engagement Letter, a review of this item would enable the Service to determine the nature of the audit, what areas respondent audited and what tasks were performed by the respondent.

5. The Management Letter, item 2, as explained in Special Agent Armstrong's affidavit, would set forth any deficiency in the record keeping methods which may result in an incorrect return. Put another way, the "Management Letter" to the client sets forth any deficiencies in internal control brought to light by the auditor's study and evaluation of the taxpayer's accounting system which may have resulted in the filing of an incorrect tax return. Such evaluation may also establish the level of culpability, that is, whether the internal controls were deficient at a low level ministerial or functional level or at the taxpayer's managerial level. At the very least, the management letter would indicate whether, in regard to the deficiencies highlighted by the accountant, the return was correct.

6. As a matter of clarification, the Representation Letter (item 3) is a form of disclosure from the client to the auditor which sets forth, among other things, statements as to the completeness and correctness of all liabilities, including possible additional income taxes, which are the result of the items improperly recorded on the taxpayer's books and also any other matter concerning which the auditor may have requested a representation.

7. Item 5, the standard work paper index, would assist the Service in determining whether it had obtained all the work papers of the taxpayer. If a document was noted on the index and it was not furnished to the Service, the index would help the Service determine the existence of the missing document.

8. Item 7, the work paper review file, would help identify the employees of the respondent who worked on different aspects of the audit. For example, if the Service had a question concerning the work papers furnished to the Service, the work paper review file would help to identify the employee of respondent who drafted the work paper. This individual could possibly also testify with respect to the taxpayer's records and its liabilities in regard to the particular area audited.

9. The engagement planning questionnaire (item 8), when read in conjunction with the engagement letter, would indicate the scope of the audit. Obviously, if the audit was not involved with areas which are the subject of the investigation it would be unnecessary to examine the records further.

10. The audit work papers file and tax pool analysis file are relevant because the items contained in those files would indicate the specific items of questionable deductibility that the taxpayer possibly claimed for the relevant tax years. The tax pool analysis file, or tax accrual papers file is compiled after the accountant has completed the audit and has identified various questionable items. To account for these questionable items, the accountant allocates a certain amount on the financial statement as a contingency for reserves. In order to arrive at the amount that should be carried as a contingency for reserves on the financial statement, the accountant must determine either that certain items are not deductible, or that there could reasonably be a liability with respect to these items. For example, the accounting firm could become aware of the liability in 1975 as a result of an improper deduction taken in 1972. Or, the accountant may question the treatment of a certain expenditure on the taxpayer's books. Both of these situations may result in the accountant allocating an amount to the contingency for reserves. It is only in the work papers and contingency for reserve files that these specific items are identified. Schedule M, for example, only shows the total contingency for reserves, and does not identify specific items. An examination of the specific items questioned would assist the Service in determining the tax-

payer's tax liabilities. For these reasons, both the audit work papers and the tax pool analysis, or contingency for reserves, files would obviously disclose information relevant to the taxpayer's income tax liabilities.

/s/ HARRY REITER
HARRY REITER

Sworn to before me this 15th day of January, 1980.

/s/ LYNWOOD HAYES
LYNWOOD HAYES
Notary Public

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

M-18-304

UNITED STATES OF AMERICA

v.

ARTHUR YOUNG & COMPANY, DEFENDANT.

Before: HON. KEVIN THOMAS DUFFY, *District Judge.*
New York, New York
January 3, 1980—11:30 a.m.

Appearances:
ROBERT B. FISKE, JR., Esq.,
United States Attorney
For the Government,
BY: KENT STAUFFER, Esq.,
Assistant United States Attorney.

OBERMAIER, MORVILLO, ABRAMOWITZ & FITZPATRICK, P.C.,
Attorneys for Defendant,
BY: ROBERT G. MORVILLO, Esq.,
of Counsel,

-and-

CARL D. LIGGIO, Esq.,
Attorney for Defendant.

[2] THE COURT: According to the calendar, there are two motions here.

MR. LIGGIO: I believe there is only one motion on the calendar, your Honor.

THE COURT: There had better be, because someone calendared two motions, a motion for a stay of proceeding, which Judge Werker denied, and if this is a rehearing of his denial, consider it reheard and denied again.

MR. MORVILLO: Your Honor, I don't think anyone calendared it. I think it was just simply a clerical mistake.

THE COURT: Okay. I took care of that one.

MR. LIGGIO: If it please the court, your Honor—

THE COURT: No, we will start with the government. I will be back to you.

MR. STAUFFER: Thank you, your Honor—

THE COURT: You won't thank me after I am finished with you.

MR. STAUFFER: This is a petition by—

THE COURT: I know what it is. You have fifteen categories here. Do you want the engagement letter? If so, why? That is category 1. Don't look at it; it is there.

[3] MR. STAUFFER: I am substituting for Ms. Trager, who is on trial, and I may be unfamiliar with the papers in the case.

THE COURT: What do you want the engagement letter for?

MR. STAUFFER: It may well be relevant to the scope of any inquiries that the auditors may have made.

THE COURT: How? You know they are engaged. Why do you want it?

MR. STAUFFER: The engagement letter defines the scope of any inquiries that an accounting firm may make. It may indicate particular areas of concern outlined. It is very difficult to tell.

In effect, a large part of the responses being made by Arthur Young and by Hess is to the extent—

THE COURT: How is it relevant?

MR. STAUFFER: It is relevant in determining the scope of inquiries that the auditors may have made.

THE COURT: You are starting an inquiry here and you don't know what the scope of the inquiry is?

MR. STAUFFER: How could we know, your Honor? We have not had an opportunity to examine documents. The whole argument here is that the government should know the answers before they ask the questions.

[4] THE COURT: Have you asked for this from Hess?

MR. STAUFFER: Hess, as your Honor is aware, has not complied, absent enforcement, with any of the summonses issued to it.

THE COURT: Did you ask it from Hess?

MR. STAUFFER: I do not know.

THE COURT: How about the management letter, what does that have to do with the relevancy to your investigation?

(Pause)

MR. STAUFFER: First of all, I direct your Honor's attention to the affidavit of G. Robert Armstrong, submitted in this case, and in particular the affidavit sworn to April 6, 1979—I am sorry, not in this case, with respect to N. Tannenbaum, but it contains a recitation of definitions with regard to these documents.

With reference to the management letter, as referred to by Agent Armstrong, who is involved in the investigation of Hess, the management letter is a letter from the respondent to the taxpayer describing the deficiencies in the taxpayer's records. That is obviously relevant to a determination of whether there is liability due, whether there is income tax reported—

THE COURT: All right. Representation letter?

[5] MR. STAUFFER: That is defined by Agent Armstrong as a letter from the respondent—

THE COURT: Again, in the affidavit in the other case?

MR. STAUFFER: A management letter is a term which applies generally to auditing firms.

THE COURT: The representation letter.

MR. STAUFFER: The same thing, your Honor, to the extent that the government is not in possession of any of the documents of Arthur Young, to require specification. This is the first summons I am aware of issued to Arthur Young in this case and to require the government to specifically identify—

THE COURT: Have summonses been issued to the taxpayer?

MR. STAUFFER: Yes, and they have not been complied with. The government doesn't have the documents, in large part. In any event, these documents are inherent records the auditor would have. Moreover, there is no prohibition against the government seeking records from whomever has them—

THE COURT: You don't have to get so hostile about it.

What do you need the history file for?

[6] MR. STAUFFER: The government has—I believe the government is not seeking enforcement with respect to the history file.

THE COURT: History file is withdrawn.

MR. STAUFFER: That is also true with respect to the—

THE COURT: You are withdrawing that now.

The standard workpaper index, what do you need that for?

MR. STAUFFER: Just a minute, your Honor. I am sorry, the history is being sought and I would direct your Honor's attention to the affidavit of Agent Armstrong in this case, sworn to July 19, 1979, which says that of the seventeen categories recited in the summons, the categories enumerated, 6 and 11 are not sought.

THE COURT: So the government submits, is that what you are saying? What happened to the history file?

MR. STAUFFER: The government is seeking production of the history file.

THE COURT: Why? What is it relevant to?

MR. STAUFFER: If I could see it, I could tell exactly what is in it, and absent seeing it—

THE COURT: Why don't you just file a subpoena saying, "Give us all your papers, each and every kind of [7] paper and make copies of them and let us rummage through everything in your files, and whatever we decide is relevant, then we can say it is relevant, and until such time as we see them we can't say it. So, Arthur Young, turn over your warehouse to us."

MR. STAUFFER: What is the alternative, where the government has not had an opportunity to inspect the records?

THE COURT: I ask you whether the government can go plopping through everybody's files willy-nilly?

MR. STAUFFER: The government has the right to subpoena whatever records may have bearing—

THE COURT: Do you want to withdraw this subpoena and issue a subpoena saying, "Give us all your files, all your files No. 1, No. 2, No. 3, No. 4," and you can break it down into "all your files"—

MR. STAUFFER: That objection can be made about everything the government asks for, unless it says, "Give us the sales receipts for the sale of an oil well; give us specific things like that."

That, I submit, is not what Congress had in mind—

THE COURT: Is there supposed to be some kind of reasonable limit on "all your files"? At this point [8] you tell me the investigation has no legitimate purpose. That is what you say to me.

MR. STAUFFER: I don't say that at all, your Honor.

THE COURT: You don't know what is relevant and you don't know what you are investigating.

MR. STAUFFER: Everything is relevant. The tax return is being audited here. Every commercial activity—

THE COURT: Why don't you ask for every paper in all the files?

MR. STAUFFER: Because we have explicitly set forth these categories to the extent the IRS can do it.

THE COURT: You are going to a third party, not to the taxpayer.

MR. STAUFFER: Because the third party has documents which may shed light on the tax returns of the corporation.

THE COURT: Why don't you go to the taxpayer first? Why haven't you gone ahead, as apparently you have, with enforcement against the taxpayer and abide the event as to third parties until you find out what you are looking for?

MR. STAUFFER: Abiding the events means it could [9] be drawn out for years and years.

THE COURT: That means you go through the normal process of court review. What you do is avoid court review in one ciruit by running into another circuit and trying to grab all the papers there.

MR. STAUFFER: Your Honor, that is not true. Any time we would seek papers from Arthur Young, we would come to this circuit because of the principal office being here.

I submit, your Honor, there is no basis in law—

THE COURT: There is no basis in law if you can't tell me what is relevant.

MR. STAUFFER: The relevance is that these documents may shed light upon the myriad commercial transactions that Amerada Hess engaged in.

THE COURT: Which transactions are you interested in?

MR. STAUFFER: Your Honor, this is an audit. Amerada Hess reported income taxes for all of their commercial activities. They are all subject to audit by the IRS. To say the IRS can only focus on things where they have a preexisting knowledge that—

THE COURT: You are dealing with a third party, not the taxpayer.

[10] MR. STAUFFER: Who has records bearing on the taxpayer.

THE COURT: It is still a different beast. You are dealing with a third party?

MR. STAUFFER: Yes, and that has no relevance to the scope of the summons.

THE COURT: Absolutely it does. Who do you think is going to pay for this?

MR. STAUFFER: The government.

THE COURT: For everything, including all of the expenses borne by Arthur Young? Yes or no. It makes a difference.

MR. STAUFFER: Your Honor, when Congress set forth the third-party summons provision, they anticipated the types of claims about burden Arthur Young is making here. In Section 7610 they provide for reimbursement of reasonable costs to comply with the summons.

THE COURT: Does that include paying for all the partners and all the rest of it who might be taken off in connection with this audit—if you are going to act like a spoiled boy, Counsel, sit down.

THE STAUFFER: I will simply refer your Honor to the terms of Section 7610, which defines the areas for which reimbursement may be sought. I submit that is a [11] sufficient basis for answering the burden claims they raise. I will note that the IRS has offered to conduct the inquiry at Arthur Young's office so that there will be minimal disruption, if any, of the normal auditing practices and procedures they are engaged in; there will be no transportation of rec-

ords from one office to another office in connection with that, if they would be willing to undertake it there and they can seek their reasonable costs under reasonable costs under Section 7610.

THE COURT: Any of these items you are willing to give to the government?

MR. LIGGIO: Yes, your Honor.

Back in1978, when Mr. Kalemba first served us with a subpoena, I said to him, "Look, you are overly broad, but if you tell us what you want by subject matter, and I think you are in a position to do that, you have audited Amerada Hess for years and you have the records available for '72, '73 and part of '74, notwithstanding the representations of the government—tell us what you want and we don't say you can't have the documents. We are prepared to work with you and make documents available to you and we are perfectly willing, if the government says they need something relating to drilling costs for the domestic production, you know, subject matter categories, [12] we will go into our papers and find them."

What we did not want to do was turn over to the government 250,000 pieces of paper and let them roam through it in areas which have no relevancy to the subject of the investigation, and in particular the one area, as my letter to you indicated and as my papers are particularly concerned about, the tax accrual papers.

I offered to the government, to Mr.Kalemba and Ms. Trager, to tell us what they want and we will make our personnel available—

THE COURT: Well, they won't tell me, either, so don't feel put out.

Mr. Morvillo?

MR. MORVILLO: With regard to that issue, Judge, I should point out to you that the focus of your question is entirely correct.

The IRS, since the inception of this audit in 1975, has given us some 400 civil document requests and we have given them documents in response to 398 of them. While the government contends that they have no ability to get any

information from Amerada Hess, that is simply totally inaccurate.

THE COURT: They can't figure out what is relevant; that is their problem.

[13] MR. MORVILLO: They have gotten hundreds of thousands of documents from us during the course of this audit. The real problem is that they have a questionable-payments investigation and what they are trying to do is to see whether or not there is anything in the entire warehouse of Arthur Young that relates to the questionable payments.

I would suggest to you, your Honor, the appropriate way to word the summons would be that, "Give us all documents in your possession relating to questionable payments."

We still have additional arguments pending in the Third Circuit and I don't want to waive.

THE COURT: I am not suggesting you have to waive.

MR. STAUFFER: Your Honor, if I might reply, there is no suggestion, from what Mr. Morvillo just said, that in all of the documents Hess may have turned over is included the documents sought by this summons. That is a necessary element that has to be shown.

THE COURT: Is there anything in all of these documents which Mr. Morvillo claims have been turned over which would indicate to you what you are looking for?

MR. STAUFFER: Your Honor, the requirement under [14] United States v. Powell, which is met by the affidavits in this case—

THE COURT: That is your opinion, Counsel.

MR. STAUFFER: There is no contravention of that in any other affidavits. I am not here to testify. I am referring to the affidavits that are of record.

THE COURT: Sit down.

Reserved.

MR. STAUFFER: I want to add one thing, your Honor.

THE COURT: No, you have added too much already.

MR. STAUFFER: With respect to the—

THE COURT: Counsel, up to this point, you have added not too much light, I must admit, and if this is going to be something enlightening, I will take it. Otherwise, forget it.

MR. STAUFFER: With respect to the claim by Hess and Arthur Young with respect to work product material, I want to bring to the Court's attention the decision of the Sixth Circuit in United States v. Upjohn, 600 F.2d 1223, Sixth Circuit (1979), where they held that the work product doctrine doesn't apply to summons-enforcement matters.

THE COURT: In certain situations. That is not [15] too enlightening.

MR. MORVILLO: We only got the government's papers yesterday.

Would your Honor give us until—

THE COURT: Friday.

MR. STAUFFER: Your Honor, is that for briefs or just affidavits?

THE COURT: They are replying.

MR. STAUFFER: They are not replying. This was the government's reply brief submitted to your Honor yesterday.

THE COURT: They want to make a comment about your reply brief.

— — —

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

M-18-304

UNITED STATES OF AMERICA,

v.

ARTHUR YOUNG & COMPANY, RESPONDENT,

and

AMERADA HESS CORPORATION, INTERVENOR.

AFFIDAVIT

STATE OF NEW YORK)
COUNTY OF NEW YORK : ss.:
SOUTHERN DISTRICT OF NEW YORK)

ROBERT G. MORVILLO, being duly sworn, deposes and says:

1. I am a principal in the firm of Obermaier, Morvillo & Abramowitz, P.C., counsel for Intervenor Amerada Hess Corporation (hereinafter "Amerada").

2. This affidavit is submitted in support of Amerada's and Arthur Young & Co.'s (hereinafter "Arthur Young") motion to reargue pursuant to Rule 9(m) of the General Rules of the United States District Court for the Southern District of New York and pursuant to Rule 60(b) of the Federal Rules of Civil Procedure to be relieved of the order of this Court dated August 26, 1980 enforcing in part an IRS summons served upon respondent Arthur Young.

3. The Court in its opinion (p.11) enforcing the summons as to the tax accrual files stated that "the IRS has made, by affidavit, the showing of relevance required by Powell". The Court appears to have interpreted this text to be that the documents sought "may be" relevant or "might have thrown light upon the correctness of the taxpayer's return". *See United States* v. *Noall*, 587 F.2d 123, 125 (2d Cir. 1978).

4. The affidavit submitted by the IRS (after oral argument on the motion and without permission of the Court) which the Court deemed sufficient to establish relevance states, in pertinent part:

> "The audit work papers file and tax pool analysis file are relevant because the items contained in those files would indicate the specific items of questionable deductibility that the taxpayer possibly claimed for the relevant tax years. The tax pool analysis file, or tax accrual papers file is compiled after the accountant has completed the audit and has identified various questionable items. To account for these questionable items, the accountant allocates a certain amount on the financial statement as a contingency for reserves. In order to arrive at the amount that should be carried as a contingency for reserves on the financial statement, the accountant must determine either that certain items were not deductible, or that there could reasonably be a liability with respect to these items. For example, the accounting firm could become aware of a liability in 1975 as a result of an improper deduction taken in 1972. Or, the accountant may question the treatment of a certain expenditure on the taxpayer's books. Both of these situations may result in the accountant allocating an amount to the contingency for reserves. It is only in the work papers and contingency for reserve files that these specific items are identified. Schedule M, for example, only shows the total contingency for reserves, and does not identify specific items. An examination of the specific items questioned would assist the Service in determining the taxpayer's tax liabilities. For these reasons, both the audit work papers and the tax pool analysis, or contingency for reserves, files would obviously disclose information relevant to the taxpayer's income tax liabilities." (Reiter affidavit, ¶ 10).

5. While the Reiter affidavit may be sufficient to establish the burden of the IRS in the ordinary general civil audit where the IRS seeks to verify deductions and discover whether the reserves undercut claimed deductions, given the facts of this case, where the IRS concerns are far more

specific and defineable, we believe that the Reiter affidavit is factually and legally insufficient.

6. This is not the ordinary civil audit wherein the IRS seeks generally to verify the accuracy of the tax return in question. Rather the instant summons was issued by a Special agent of the IRS in furtherance of a joint investigation, the civil aspects of which have, the Company understands, been substantially concluded, expect for a portion of the 1974 investigation.

7. The criminal phases of this joint investigation are not yet completed. They are described in the affidavit of G. Robert Armstrong, annexed to the petition to enforce, as follows:

> "The taxpayer has disclosed that it maintained a fund called a 'special disbursements account.' From this fund, it made political contributions, some of which were reimbursed to the actual contributor, and charged to 'legal fees,' gave gifts to foreign government employees and deducted the same as 'other deductions;' gave sums to members of local police and fire departments and deducted the same as 'cleaning services,' made payments, which were deducted, to a foreign 'expeditor,' and engaged in other possibly illegal activity. The taxpayer formed a Special Committee of its Board of Directors to investigate the practices of the corporation and its subsidiaries with respect to cash funds, payment to foreign government officials, and illegal, non-deductible, or questionable payments. A Report to the Board of Directors by the Special Committee regarding the questionable payments disclosed the respondent's participation in the Special Committee's investigation.

8. More recently, in a related litigation pending in the United States District Court for New Jersey, after referring to the Special Committee's investigation, Armstrong swore:

> "My investigation concerns the same payments and accounting procedures. Under the revenue laws, bribes, kickbacks and improper or illegal payments are not deductible corporate expenses, and the false accounting for such deductions (if taken) might constitute tax evasion.

"My investigation therefore concerns whether and to what extent Amerada may owe additional taxes or may have violated the criminal provisions of the Internal Revenue Code, and specifically but not exclusively whether it evaded its taxes for the years under investigation through the use of slush funds or other 'questionable' payments."

9. Thus, unlike the ordinary civil audit where the Court is faced with determining what "may be" relevant in the abstract, the instant fact situation permits the Court to determine with precision whether the tax accrual files "may be" relevant to the specific issues being scrutinized by the IRS in this case.

10. Indeed since the original papers were filed with the Court in January, 1980, the IRS has conducted 36 sworn interviews of employees, officers and directors of Amerada. These interviews (the transcripts of which are being filed with the Court as part of these papers)* demonstrate unequivocally the precise areas of the instant investigation. All of the interviews have been virtually identical in terms of questions asked.

11. In specific terms, they deal with

a. one $200 illegal political campaign contribution (which was fully and accurately reflected on the corporate books);
b. two political campaign contributions totalling $550, one of which was possibly illegal, made by a foreign subsidiary to local politicians in the Virgin Islands (and not deducted on Amerada's Federal tax return);
c. transactions in Abu Dhabi, Iran and Ecuador;
d. payments intended for local police and fire officials.

In addition, all witnesses have been asked general questions about whether they have knowledge of any other foreign or domestic bribes, kickbacks, slush funds or corporate political campaign contributions and all have answered negatively.

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*These transcripts will be referred to hereinafter as "Appendix" with the name of the witness and the page of the deposition.

12. Specific analysis of the 36 sworn interviews that have taken place to date supports our position that the tax accrual file is irrelevant. As noted above, the agents in charge of of the joint investigation have asked each witness almost the exact same questions. These questions are broken up into eight series of documents pertaining to so-called questionable payments. Indeed, examination of these areas in the context of the Amerada tax returns demonstrates that they are absurd on their face and are no longer being asked for any legitimate purpose.

13. *Husseim Awadba and Abu Dhabi*—The agents have asked each witness about Husseim Awadba, a resident of the country of Abu Dhabi and his receipt of $613 in 1973 and $718 in 1974. The agents have been informed by Mr. Cassidy, an assistant controller that Mr. Awadba was "a messenger-type person" who would assist Amerada with visas and the like. (Appendix, Cassidy 19-21). No one, including the Special Committee, implicated Mr. Awadba in any improper or questionable activities.

The agents have also asked whether any witness has knowledge of bribes, kickbacks and the like to government officials in Abu Dhabi and have received a universal no.

14. *Gifts to Government officials in Abu Dhabi*—Among the findings of the Amerada Special Committee was the fact that *petty* gratuities were given to some foreign officials in the form of sheep, wristwatches and the like. The agents have asked all witnesses about such gifts in Abu Dhabi and have been informed that various officials were given four pieces of crystal (wedding gift), one color t.v., one gold watch and some sheep (at the conclusion of Ramadam, a religious holiday). (Appendix, Trynin 7-15, Cassidy 26-29). No large or corruptive type gifts have been suggested.

15. *Gratuities to local police and fire officials*—The Amerada Special Committee reported that payments had been made by the Company to local police and fire officials amounting to approximately $2,000 per year. When the Company became aware that these payments had been improperly recorded on the books of the Company, it quickly consented to the disallowance of these deductions.

The Agents have questioned all witnesses about these payments and have been informed that these payments were being made to obtain the good will of the police in a high crime area in connection with a local gas station when the company purchased the station in the 1960's. They continued until 1976 when they were discontinued shortly before the Special Committee was created. (Appendix Goldberg 11-16; Moody 10-16, Mahaney 11).

16. *Use of the Corporate Aircraft*—The Agents have shown each witness certain extracts from the log of the corporate aircraft. They have focused on two or three trips of three officials of the National Iranian Oil Company and have been informed that Amerada and the National Iranian Oil Company were working on a joint venture of building refining units in the Virgin Islands. The Iranian officials wanted to visit the refineries and, while in the Virgin Islands, several other islands. Thus, the trips were for legitimate business purposes. (Appendix, Hess p. 24).

They have also inquired as to knowledge of any bribes or kickbacks to Iranian Government officials and have again been assured by all witnesses that no such bribes or kickbacks took place.

17. *Azar-Pey and Ghadami-Navai*—The Agents have asked all witnesses about Messrs. Azar-Pey and Ghadami-Navai, residents of Iran and have been informed that both of these gentlemen were employees of the National Iranian Oil Company (NIOC) and were assigned by NIOC to work at Bushco—an Amerada/NIOC joint venture. Because these gentlemen were being asked to work in accordance with American standards and hours, rather than Iranian, they were given extra compensation by Amerada for their additional work with the full knowledge of NIOC. (Appendix, Hess deposition, p. 27-29).

18. *$750 of political campaign contributions*—The Agents have inquired of each witness about the purchase of tickets to a luncheon for Julia Butler Hansen, who was running for Congress in 1972. They have been informed Mr. Hess authorized the purchase of $200 worth of tickets. Since this contribution was listed accurately on the books

and records of Amerada, it is clear that the deduction was inadvertent.

The agents have also inquired about two other political campaign contributions in the amount of $550 made with corporate funds. However, neither of these contributions was deducted by Amerada since they involved funds of Hess Oil Virgin Islands which is a foreign corporation and not a part of Amerada's consolidated return.

19. *Dr. Burneo and Ecuador*—The agents have inquired about Amerada's payment of consulting fees to Dr. Raymon Burneo, who was the Ecuadorian Ambassador to West Germany. Again the answers have indicated that these were legitimate payments for consulting services and, in addition, were charged to a foreign subsidiary not included in Amerada's consolidated return and thus have no U.S. tax consequences. (Appendix, Jacobson 25-30).

Indeed, the Company went beyond the interviews in this instance to supply the IRS with documentary proof positive of these facts. (See Exhibit A annexed hereto.) Despite this documentation the agents, by rote, continued to inquire on this matter of all witnesses.

20. *J. Yagchi and Abu Dhabi*—The agents have inquired about J. Yagchi, his corporation and one of his employees in Abu Dhabi. They have been informed that Mr. Yagchi and his employees gave advice about local problems and supplied services to the company in Abu Dahbi such as translation of documents, customs matters and the like. (Appendix, Trynin 30, O'Brien 16). Nothing improper or questionable has ever been suggested about these services.

21. In addition to the foregoing specific question areas, the Agents have asked each witness generally about domestic and international bribes, kickbacks, slush funds and secret bank accounts. In every instance, the witnesses have stated that there were no such questionable payments other than as described in paragraphs 13 to 20 above.

22. The foregoing demonstrates clearly that IRS now has more than sufficient information to make an informed judgment about the company's tax liability in the questionable payment area. The IRS has received detailed answers about each specific transaction under investigation. With

the exception of the one $200 campaign contribution for luncheon tickets and the $2,400 per year payments to police and fire officials, there are no questionable items.

These interviews should be viewed in the context that they are completely consistent with the findings of the Special Committee.

The Special Committee was composed of Mr. Ricardo A. Mestres (a retired financial Vice President of Princeton University); Mr. Jack G. Copeland, Jr. (retired Vice President and Director of Hercules, Inc.); Mr. Harry C. Hagerty (retired Vice Chairman of Metropolitan Life Insurance Co.); and, Mr. William S. Renchard (formerly Chairman and Chief Executive Officer of Chemical Bank). It was assisted by the law firm of Milbank, Tweed, Hadley & McCloy and the accounting firm of Arthur Young. It is doubtful in the extreme that any of the aforementioned participants would file a dishonest report.

In addition, it should be noted that two directors, who were members of the Special Committee and four of the top officers of the Company filed affidavits indicating that they know of no other questionable payments other than those listed above.

23. A partner of Arthur Young in a letter sworn to under penalty of perjury has affirmed these affidavits. Because that partner was in charge of the Amerada audit and had access to the tax accrual file, he could not have affirmed those affidavit if the tax accrual file contained any additional or inconsistent evidence of questionable payments.

24. Thus, in the face of the Special Committee report, the affidavits of the officers and directors of the Company, the sworn affirmance of Arthur Young and the sworn testimony of 36 employees, officers and directors of the company, all of which reveal a total of some $8,000 of questionable payments in years during which the Company paid $57,000,000 in federal income taxes, one must challenge the good faith of the IRS in contending that the tax accrual file is relevant.

25. Thus, the pertinent question before the Court should no longer be whether the tax accrual files may be relevant to some general verification of Amerada's tax liability since

the Company understands that the IRS has satisfied itself as to all issues for 1972 and 1973 and substantially all issues for 1974 other than the open questionable payments investigation for the three years. Rather, we submit that the question is whether the tax accrual file "may be" relevant to the specific open items, to wit, the alleged questionable payments under continuing investigation.

26. Arthur Young has submitted the affidavit of Bruce Greenwald (annexed as Exhibit B to the answer of Arthur Young) which affidavit states that a review of the tax accrual workpapers reveals "no information whatever in the tax accrual workpapers relative to any alleged bribes or other matters covered by the Special Commiteee's Report" (affidavit of Bruce Greenwald, Dec.26, 1979). Thus, unless this affidavit is questioned or refuted in some way by the IRS, there is nothing in the record to sustain the burden of the IRS of demonstrating the relevance of the tax accrual file to questionable payments.

WHEREFORE, it is respectfully submitted that the within motion be granted and that the Court enter an order denying the enforcement of the summonses.

/S/ ROBERT G. MORVILLO
ROBERT G. MORVILLO

Sworn to before me this 17th day of September, 1980.

/S/ KATHERINE HOR
KATHERINE HOR
Notary Public

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

M-18-304

UNITED STATES OF AMERICA, PETITIONER,

v.

ARTHUR YOUNG & COMPANY, RESPONDENT,

and

AMERADA HESS CORPORATION, RESPONDENT-INTERVENOR.

AFFIDAVIT

STATE OF NEW YORK)
COUNTY OF NEW YORK : ss.:
SOUTHERN DISTRICT OF NEW YORK)

ANTHONY CAPUTO, being duly sworn, deposes and says:

1. I am employed as a Revenue Agent in the office of the District Director of the Internal Revenue Service ("IRS"), Newark District, with a post of duty at Mountainside, New Jersey. In my capacity as an IRS Revenue Agent, I am conducting a joint investigation with Special Agent G. Robert Armstrong, one purpose of which is to ascertain the correctness of the tax returns filed by the Amerada Hess Corporation ("Amerada" or "the taxpayer") for the tax years 1972, 1973 and 1974.

2. The civil aspects of the investigation are open and ongoing for each of the tax years under investigation. While with respect to certain matters the IRS has informed Amerada of proposed civil tax adjustments, no formal report of examination has been issued to the taxpayer. The proposal of adjustments during the course of a civil audit is a routine IRS procedure, and the fact that proposed adjustments have been made to a taxpayer does not preclude further adjustments in the event evidence of additional liability is obtained.

3. The tax pool analysis files developed by Arthur Young & Company ("Arthur Young") for Amerada are relevant to the civil audit because the information contained in those files reasonably may be expected to indicate specific items of questionable deductibility that Amerada possibly claimed for the relevant tax years and could provide the basis for adjustments of Amerada's tax liability. The information, for example, also may bear upon the issue of corporate intent, a factor pertinent to the assessment of civil fraud or other penalties.

4. Because this is a joint investigation, the tax pool analysis files which are relevant to the civil audit have been requested by Special Agent Armstrong. Neither the tax pool analysis files nor, to my knowledge, the data contained within them, are in the possession of the IRS. It is necessary for the IRS to examine the Arthur Young tax pool analysis files in order that the civil audit of Amerada may be completed and the correctness of the tax returns filed by Amerada for the years under investigation may be ascertained.

/s/ ANTHONY CAPUTO
ANTHONY CAPUTO

Sowrn to before me this 21st day of November, 1980

/s/ PAULINE P. TROIA
PAULINE P. TROIA
Notary Public

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

M-18-304 (KTD)

UNITED STATES OF AMERICA, PETITIONER,

v.

ARTHUR YOUNG & COMPANY, RESPONDENT,

and

AMERADA HESS CORPORATION, RESPONDENT-INTERVENOR.

AFFIDAVIT

STATE OF NEW YORK)
COUNTY OF NEW YORK : ss.:
SOUTHERN DISTRICT OF NEW YORK)

G. ROBERT ARMSTRONG, being duly sworn deposes and says:

1. I am employed as a Special Agent in the Office of the District Director of Internal Revenue, Newark District, with a post of duty at Toms River, New Jersey. In my capacity as a Special Agent, I am conducting a joint investigation with Revenue Agent Anthony Caputo, one purpose of which is to ascertain the correctness of the tax returns filed by the Amerada Hess Corporation ("Amerada") for the tax years 1972, 1973 and 1974.

2. This is a joint investigation conducted by the Examination and Criminal Investigation Divisions. The investigation is continuing to date. No recommendation for criminal prosecution has been made by the Internal Revenue Service to the Department of Justice with respect to the matters under investigation. I have not yet made, nor am I yet in a position to make, any recommendation one way or the other to my supervisor pending further investigation.

3. One aspect of the joint investigation concerns whether Amerada evaded its taxes for the years under investigation through the use of "slush funds" or other questionable pay-

ments. Between the dates June 2, 1980 through August 27, 1980, I conducted 36 sworn interviews with employees, officers and directors of Amerada, as well as two partners of Arthur Young & Company ("Arthur Young"), an accounting firm retained by Amerada during the years under investigation. The names of the 36 individuals I interviewed were provided to me by Amerada as persons who previously had been interviewed by a Special Committee formed by Amerada's Board of Directors to investigate the practices of the corporation and its subsidiaries with respect to cash funds, payments to foreign government officials, and illegal, nondeductible or questionable payments. Based upon information which had been disclosed by Amerada at that time concerning possible illegal or questionable payments made by Amerada, I questioned each of the witnesses concerning his personal knowledge of such matters.

4. In addition, I posed certain questions to the members of Arthur Young whom I interviewed concerning whether Arthur Young maintained tax pool analysis files for Amerada for the years under investigation. I was informed that Arthur Young maintained such files, but I was not permitted to inspect such files nor was I provided with any facts as to the specific information contained in the files. Nothing which I learned from the aforesaid 36 interviews has caused the IRS to narrow the scope of the joint investigation in any fashion, and the IRS's inquiry continues as to all aspects of Amerada's tax liability for the tax years 1972, 1973 and 1974.

5. It is necessary for me to examine the Arthur Young tax pool analysis files in order that I may ascertain the correctness of the tax returns filed by Amerada for the years under investigation and determine whether and to what extent Amerada may owe additional taxes or whether the assessment of civil penalties is warranted. The tax pool analysis files are highly relevant to this investigation because the items contained in these files would disclose, among other matters, the specific items of questionable deductibility that Amerada may have claimed for the tax years under investigation. Neither the tax pool analysis files nor, to my knowledge, the data contained within them are in the possession

of the IRS. Because the IRS has not been permitted to review the tax pool analysis files, the IRS cannot determine whether information disclosed to date by Amerada in the interviews and otherwise is corroborated or impeached by the tax pool analysis files or whether data contained in these files would disclose additional areas of tax liability.

/s/ G. ROBERT ARMSTRONG
G. ROBERT ARMSTRONG

Sworn to before me this 21th day of November, 1980.

/s/ PAULINE P. TROIA
PAULINE P. TROIA
Notary Public

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

M-18-304

UNITED STATES OF AMERICA, PETITIONER,

v.

ARTHUR YOUNG & COMPANY, RESPONDENT,

and

AMERADA HESS CORPORATION, RESPONDENT-INTERVENOR.

REPLY AFFIDAVIT

STATE OF NEW YORK)
COUNTY OF NEW YORK : ss.:
SOUTHERN DISTRICT OF NEW YORK)

ROBERT G. MORVILLO, being duly sworn, deposes and says:

1. I am a member of the firm of Obermaier, Morvillo & Abramowitz, P.C., attorneys for respondent-intervenor Amerada Hess Corp. ("Amerada"). This affidavit is submitted in response to the affidavits of Agents Armstrong and Caputo which were submitted in opposition to respondent's motion for reargument of and relief from this Court's order of October 26, 1980 enforcing an IRS summons.

2. It is submitted that the affidavit of Revenue Agent Caputo demonstrates that Amerada's argument herein is valid. Caputo conceded that he has already given proposed civil tax adjustments to Amerada. (Caputo Affidavit, November 21, 1980, ¶ 2). While IRS has the power to amend these at any time before settlement, it is clear that they would not be given out unless the civil audit is substantially completed. Certainly if there was any real civil purpose in attaining the tax pool analysis documents, such adjustments would have been withheld until the documents were produced.

3. The Caputo affidavit represents a clear attempt to divert the Court's attention from the real and already articulated motive of IRS for seeking the tax pool analysis documents. Arguing that the civil audit is still technically open and that therefore the IRS may change their proposed adjustments after reviewing the documents begs the question of relevance.

4. In determining the issue of relevance of the tax accrual files, the Court should consider not what the theoretical basis of the summon is, but the true purpose for this particular summons issuance. The record of this proceeding indicates clearly that the sole motive for seeking the tax pool documents is to determine whether they contain information helpful and relevant to the criminal investigation.

5. Thus, in the original petition seeking enforcement Agent Armstrong supported the summons for the documents in question as follows:

> "*Tax Pool Analysis File*—(Tax contingency file) File containing a memorandum, letter or other document, which recommends to the taxpayer that possible contingent liability for taxes be set up. *For example, if the taxpayer had paid bribes overseas and this was discovered by respondent, then the respondent would have the taxpayer set up a contingent liability for taxes.* (Emphasis added). (Armstrong affidavit, July 19, 1979).

6. Moreover, at the very beginning of the criminal investigation, Amerada and IRS *agreed* that information desired for the civil audit would come from Revenue Agent requests and information sought for the criminal investigation would come from Special Agent requests. The instant summons was issued by the Special Agent.

7. When viewed in the context of the fact that IRS has already determined the proposed civil tax adjustments, there can be no other conclusion than that the true motive of IRS for requesting these documents is for the questionable payments criminal investigation. Thus, the Court must look to the scope of the criminal investigation in determining the issue of relevance.

8. As noted in our original papers, the scope of the criminal investigation, to wit, improper or questionable pay-

ments, has long been known. Our original papers also demonstrate conclusively that nothing in the tax pool analysis document is relevant to the questionable or improper payments inquiry. Thus, the summons should not be enforced because it seeks documents which are not relevant to the purpose for which it has issued.

9. At a very minimum, it is suggested that respondents are entitled to a hearing to demonstrate that the documents sought are not relevant to the purpose underlying the summons.

/s/ ROBERT G. MORVILLO
ROBERT G. MORVILLO

Sworn to before me this 8th day of December, 1980.

/s/ KATHERINE HOR
KATHERINE HOR
Notary Public

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

M-18-304 (KTD)

UNITED STATES OF AMERICA, PETITIONER

v.

ARTHUR YOUNG & COMPANY, RESPONDENT,

and

AMERADA HESS CORPORATION, RESPONDENT-INTERVENOR.

ORDER AND JUDGMENT

This proceeding having been brought on by petitioner United States of America by order to show cause issued October 9, 1979 to enforce an Internal Revenue Service ("IRS") summons served upon respondent Arthur Young & Company on April 17, 1978, and the Court having issued an opinion dated August 26, 1980, granting the United States' petition in part and denying it in part, and thereafter the Court having granted respondents' motion for reconsideration and upon reconsideration having adhered to and reaffirmed its August 26, 1980 opinion, and petitioner having moved for entry of an order and judgment and for clarification of the Court's August 26, 1980 opinion, it is therefore

ORDERED that the Court's opinion dated August 26, 1980 be modified to delete therefrom the word "workpapers" from the last line of page 12 of the slip opinion and, further, to delete the words "and workpapers" from the fifth line of page 14 of the slip opinion, and it is further

ORDERED that the petition of the United States of America to enforce the IRS summons upon respondent Arthur Young & Company on April 17, 1978, is granted to the extent set forth below, and it is further

ORDERED AND ADJUDGED that respondent Arthur Young & Company appear before IRS Special Agent G. Robert Armstrong, or his designated representative, at

10:00 A.M., within twenty (20) days of the entry of this order and judgment, at the offices of respondent where the documents to be produced are located or at an alternative location to be agreed upon by the Special Agent and respondent, then and there to be sworn, to give testimony and to produce for examination and copying the books, records and other papers demanded in the IRS summons served upon respondent on April 17, 1978, with the exception of item "11", the audit program file(s); item "12", the audit workpapers file(s), but only to the extent that the audit program is contained within these file(s); and item "14", the Special Committee workpapers, the examination to continue from day to day until completed.

DATED: New York, New York
FEBRUARY 23, 1981

/S/
United States District Judge

/s/ RAYMOND F. BURCHARDT,
Clerk

/S/ _____
Deputy Clerk

In the Supreme Court of the United States

No. 82-687

UNITED STATES, PETITIONER,

v.

ARTHUR YOUNG & COMPANY, ET AL.

ORDER ALLOWING CERTIORARI. Filed February 22, 1983.

The petition herein for a writ of certiorari to the United States Court of Appeals for the Second Circuit is granted.

Office - Supreme Court, U.S.
FILED
NOV 22 1982
ALEXANDER L. STEVAS,
CLERK

No. 82-687

IN THE

Supreme Court of the United States

October Term, 1982

UNITED STATES OF AMERICA,

Petitioner,

v.

ARTHUR YOUNG & COMPANY

and

AMERADA HESS CORPORATION,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

RESPONDENTS' BRIEF IN OPPOSITION

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QUESTION PRESENTED

Whether tax accrual workpapers prepared by an independent auditor to assist a corporate taxpayer in complying with the federal securities laws should be accorded a qualified work-product privilege in response to an Internal Revenue Service ("IRS") summons when

(a) the taxpayer's records have been examined by the IRS,

(b) the auditor's workpapers are available to the IRS, and

(c) the IRS has failed to make any showing of special need for the tax accrual workpapers?

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IN THE

Supreme Court of the United States

October Term, 1982

No. 82-687

UNITED STATES OF AMERICA,

Petitioner,

v.

ARTHUR YOUNG & COMPANY

and

AMERADA HESS CORPORATION,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

RESPONDENTS' BRIEF IN OPPOSITION

Statement of the Case

The Tax Accrual Workpapers

The Arthur Young tax accrual workpapers* contain no facts relating to Amerada's tax liability that are not either derived from or reflected in the corporation's financial and

*Independent auditor's workpapers of this nature are variously referred to as tax accrual files, tax contingent liability files, or tax pool analysis files.

transactional records and books of account or reported in publicly available documents. Amerada's records and books were produced to the IRS. Arthur Young's audit workpapers have been available to the IRS since the date of the decision below. *See* 677 F.2d at 221. As the Court below emphasized, the "corporation's own books and the audit workpapers furnish the IRS with all the raw data that it needs to calculate the taxpayer's tax liability." *Id.* at 220.

Tax accrual workpapers are prepared by an independent auditor for SEC and financial reporting purposes. They are not part of the tax return workpapers. Those sought in this case were prepared by Arthur Young, as Amerada's independent auditor, in connection with its year-end audit work and its opinion on Amerada's financial statements.

In making its assessment of the adequacy of Amerada's accrual (reserve) for potential tax liability, as reflected in its financial statements, Arthur Young evaluates the projections, hypotheses and speculations of Amerada's financial personnel as well as Amerada's books of account on a number of questions. These include, for example, tax issues which might arise in connection with various corporate transactions, possible objections which the IRS might raise in examining Amerada's returns, possible responses which Amerada might make to any such challenge, estimates of the likelihood of an administrative settlement, and estimates of the outcome of a judicial decision. Arthur Young then prepares its tax accrual workpapers which reflect its judgment, solely for financial reporting purposes, regarding the adequacy of the tax reserve as shown on Amerada's financial statements.

The Court below accordingly found that the tax accrual workpapers set forth the independent auditor's "speculation as to positions that might be taken by the IRS and taxpayer, theoretical analysis, and opinions bearing on the fairness

and reasonableness of the parties' positions (as distinguished from factual transactional data)...." 677 F.2d at 217.*

The Joint IRS Investigation of Amerada

The petition does not describe the status of the joint IRS investigation of Amerada in April 1978 when the summons for Arthur Young's tax accrual workpapers was issued. Contrary to the impression created by the petition (pet. 3), there was at that time no general IRS inquiry into the correctness of Amerada's tax returns. Rather, there was a narrow investigation, primarily criminal in direction, focused exclusively on alleged "questionable payments" by Amerada totaling less than $8,000. An IRS Special Agent (that is, a criminal investigator) was assigned to the case, and Amerada and the IRS entered into an agreement concerning the purposes for which the Special Agent's summonses would be issued. 677 F.2d at 214. The exact nature of this agreement was contested below and the record is unclear on it. *Id.* at 214, 218. The Arthur Young summons was signed by the Special Agent, *id.* at 214, and was issued at a time when the civil audit to determine the correctness of Amerada's tax returns was suspended.

Rather than assess the IRS' motive for issuing the summons, "in an institutional sense," as required by this Court's decision in *United States* v. *LaSalle National Bank,* 437 U.S. 298, 319 (1978), the Court below, for reasons of "judicial economy," assumed that the summons was in aid of the civil audit and that "the IRS [was] not attempting to prove that Amerada [was] guilty of fraud." 677 F.2d at 221. The Government vigorously contested this finding in its Petition for Rehearing and Suggestion for Rehearing En Banc, asserting that the Court's assumption "that this case does not involve a fraud investigation ... is flatly contradicted by the

* In its Manual the IRS recognizes that tax accrual workpapers consist principally of opinions and projections of the taxpayer and independent auditor rather than facts. *See I [Audit] Int. Rev. Man.* (CCH) § 232.8(4) (May 14, 1981).

record, which establishes beyond any doubt that the IRS is conducting a joint investigation of Amerada in which both civil (including civil fraud penalties) and criminal elements remain open and ongoing." Petition for Rehearing and Suggestion for Rehearing En Banc 13-14. There was, in short, considerable confusion in the Court of Appeals concerning the purpose for which the Arthur Young summons was issued, the nature of the agreement between Amerada and the IRS, and the extent to which fraud was involved in the case.

The petition is likewise misleading in its description of the Court of Appeals' holding. The Court held that "the IRS [had] not made a sufficient showing of need to override the [accountant work-product] privilege." 677 F.2d at 221. The basis for this holding was not, as the petition suggests (pet. 5), that Amerada's "own books and the audit workpapers furnish the IRS with all the raw data it needs." The reason that the IRS failed to make a sufficient showing of need, in the Court's view, was that "the IRS [was] not attempting to prove that Amerada [was] guilty of fraud." 677 F.2d at 221. The holding of the Court of Appeals was clearly limited to cases that "[do] not involve allegations of fraud." *Id.* at 220.

Reasons for Denying the Petition

I

THE DECISION BELOW IS IN ACCORD WITH THE DECISIONS OF THIS COURT

The petition argues that the creation by the lower Court of "an accountant work-product privilege, under the rationale of an accountant-client privilege," is "in derogation of this Court's ruling in *Couch* v. *United States*, 409 U.S. 322, 325 (1973), that no confidential accountant-client privilege exists under federal law, and no state-created privilege has been recognized in federal cases. . . ." (pet. 6) This argument completely misapprehends the decision below.

The lower Court did not establish a privilege for all communications between accountant and client. Nor did it reach a result based on the rationale of a general accountant-client privilege. Since the decision below neither creates nor relies on an accountant-client privilege, it does not run afoul of this Court's decision in *Couch* v. *United States,* or the decisions of lower courts following *Couch. See, e.g., In re International Horizons, Inc., Debtor,* No. 82-8024 (11th Cir. Oct. 21, 1982).

The Court of Appeals did create a qualified work-product privilege for an independent auditor's tax accrual workpapers in certain limited circumstances. In creating this privilege, the lower Court followed in the path of the Court of Appeals for the Third Circuit in *Hickman* v. *Taylor,* 153 F.2d 212 (3d Cir. 1945), which created a qualified work-product privilege for an attorney's trial preparation materials. The privilege created by the Court of Appeals in *Hickman* was approved by this Court, 329 U.S. 495 (1947), and codified in Fed. R. Civ. P. 26(b)(3).

The purpose of protecting the auditor's tax accrual workpapers is to safeguard the public interest in the auditing function, not, as in the case of an accountant-client privilege, the confidentiality of communications between taxpayer and auditor. The lower Court noted that:

> If the auditor were required to disclose this material [the tax accrual workpapers], which is not used in preparation of the taxpayer's return and is not needed by the IRS to determine the correctness of the taxpayer's return, the auditor would probably be inhibited from creating or maintaining such papers as part of a full and frank exchange useful in complying with the taxpayer's obligations under federal securities laws.

667 F.2d at 217. The Court concluded that:

> The investing public . . . relies most exclusively on the data generated as a result of the SEC laws. It therefore seems to us that this collision [between the responsibilities of the IRS and the SEC] requires that some form of

> privilege be carved out to protect the independent auditing process.

Id. at 220-21.

Like the attorney work-product privilege, the privilege for tax accrual workpapers is qualified and can be overcome by a sufficient showing of need by the IRS. *Id.* at 221. Also, like the attorney work-product privilege, the protection afforded by the privilege is limited to "documents and tangible things"—the tax accrual workpapers—which are prepared by the independent auditor in order to assist in satisfying the requirements of the federal securities laws but which in so doing reflect the settlement position and tax strategy of the taxpayer in the event of an IRS audit or litigation. *Id.* at 220.

The Court below also properly relied upon *Upjohn Co.* v. *United States,* 449 U.S. 383 (1981), in expanding the work-product doctrine of *Hickman* to include an independent auditor's tax accrual workpapers. 677 F.2d at 219-21. It noted that "neither the [Supreme] Court nor Congress expressed an intent to limit the [work-product] doctrine to the discovery context." *Id.* at 219. In *Upjohn,* this Court based its decision in part upon its concern for protecting sensitive communications where full discourse serves a public interest, where opinions and conclusions are involved, and where confidentiality is anticipated. 449 U.S. at 392-397. While the *Upjohn* decision related to attorneys, the broader overtones discernible in that decision motivated the Court below to balance "strong public policies" favoring some protection for the integrity of the market for publicly traded securities against the IRS' claimed need for the information in the independent auditor's tax accrual workpapers. 677 F.2d at 219.

II

THE DECISION BELOW IS NOT IN CONFLICT WITH THE *EL PASO* DECISION

The petition also argues that the decision below "conflicts" with *United States* v. *El Paso Co.*, 682 F.2d 530 (5th Cir. 1982), *petition for cert. filed*, No. 82-716 (Oct. 22, 1982). (pet. 6) This argument cannot be supported.

Both decisions held that tax accrual workpapers are relevant to an IRS audit. *See United States* v. *El Paso Co., supra*, 682 F.2d at 537-38; *United States* v. *Arthur Young & Co., supra*, 677 F.2d at 219. But while the Court below declined to order the production of tax accrual workpapers prepared by independent auditors in order to protect their work done "to comply with the federal securities laws," *id.* at 219, the *El Paso* court required the production of tax accrual workpapers prepared by the taxpayer. 682 F.2d at 534. The difference in the decisions turns on the difference in the authorship of the workpapers.

El Paso did not involve the question raised by the petition in this case. As the Court in *El Paso* stated, "We need not reach the issue of an accountant work product doctrine because the IRS here summoned the tax pool analysis from the taxpayer itself, not from an independent accountant". 682 F.2d at 537-38 n.7. The two cases are therefore not in conflict.

III

THE DECISION BELOW IS FULLY WITHIN THE POWER OF THE FEDERAL JUDICIARY

The petition also contends that whatever the nature of an independent auditor work-product privilege, its creation by the Court below constitutes an encroachment on legislative prerogative. (pet. 15) This contention is contrary to the decisions of this Court in *Hickman* and *Upjohn* and also ignores the express invitation to the federal courts to create new privileges extended by Congress in Fed. R. Evid. 501.

Fed. R. Evid. 501 provides in relevant part that "the privilege of a witness . . . shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience." This Court has found that Rule 501 "manifested an affirmative intention not to freeze the law of privilege" and that Congress in enacting the rule intended to " 'provide the courts with the flexibility to develop rules of privilege on a case-by-case basis' and to leave the door open to change" (quoting statement of Rep. Hungate at 120 Cong. Rec. 40891 (1974)). *Trammel* v. *United States*, 445 U.S. 40, 47 (1980). *See also, Upjohn Co.* v. *United States, supra*, 449 U.S. at 396-97 (1981); *United States* v. *Gillock*, 445 U.S. 360, 367 (1980). The legislative history of Fed. R. Evid. 501 "clearly indicates that Congress anticipated future recognition, by the courts, of privileges not recognized at the time of passage of the Rule." Garbis and Struntz, *The Second Circuit's Arthur Young Decision: A Privilege for Tax Accrual Workpapers*, 57 J. Tax'n 66, 68 (1982); *see* S. Rep. No. 93-1277, 93d Cong., 2d Sess. 12-13 (1974); 2 D. Louisell and C. Mueller, *Federal Evidence* § 200 (1978); 23 C. Wright and K. Graham, *Federal Practice and Procedure* § 5425 (1980).

The petition's assertion that the risk of SEC prosecution obviates the need for an independent auditor work-product privilege (pet. 13) ignores the rationale of *Upjohn*, in which this Court relied upon Fed. R. Evid. 501 to expand the scope of the attorney-client and work-product privileges. 449 U.S. at 396-97. There, this Court determined that these privileges should be expanded to improve the quality and depth of an attorney's investigation and to encourage the client's compliance with the law, rejecting the Government's argument that "the risk of civil or criminal liability suffices to ensure that corporations will seek legal advice in the absence of the protection of the privilege." *Id.* at 393 n.2. Following *Upjohn*, the Court below similarly reasoned that a qualified independent auditor work-product privilege was necessary to protect the public securities markets against inaccurate

financial information notwithstanding the corporate taxpayer's duty to comply with the federal securities laws under risk of SEC prosecution or civil suit. 677 F.2d at 220.

The Court below also acted pursuant to recognized judicial authority to resolve conflicts among competing Congressional policies. As this Court has observed, substantial countervailing policies of Congress can undercut the otherwise broad latitude given to the IRS in enforcing the nation's tax laws. *United States* v. *Euge*, 444 U.S. 707, 711, 716 n.9 (1980).* Relying on *Euge*, the Court below concluded that the conflict between the public interest in strict enforcement of the tax laws and in accurate, complete financial disclosure mandated by the federal securities laws "requires that some form of privilege be carved out to protect the independent auditing process." 677 F.2d at 221. In reaching this conclusion, the Court emphasized that:

> [W]e are comforted by the knowledge that if Congress feels that this privilege unduly restricts the IRS's authority, it can require that this material be made available, or that taxpayers flag their questionable positions directly on their returns, in line with the suggestions of former Commissioner Kurtz, 32 Tax Law. at 15-16; Cooper, The Avoidance Dynamic: A Tale of Tax Planning, Tax Ethics, and Tax Reform, 80 Colum. L. Rev. 1553, 1612 (1980). Procuring tax

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* *St. Regis Paper Co.* v. *United States*, 368 U.S. 208 (1961), is not to the contrary. In that case there was an express statutory provision for resolution of the conflict between the protection against disclosure of census information in section 9(a) of the Census Act, 13 U.S.C. § 9(a), and the Federal Trade Commission's right to subpoena such information under section 6(b) of its organic Act, 15 U.S.C. § 46(b). *Id.* at 219-20. Unlike this case, there was no conflict of congressional policies in *St. Regis*. In any event, the Court there did not find the alleged policy considerations against disclosure to be substantial enough to warrant the creation of a privilege. *Id.* at 218-19.

> accrual workpapers under § 7602 seems to us to effectuate Commissioner Kurtz's proposals through the back door.

Id. at 221.

Shortly after the judgment below was entered, Congress, in enacting the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Pub. L. No. 97-248, 96 Stat. 324, § 323(a), to be codified as new Internal Revenue Code § 6661, adopted Commissioner Kurtz's suggestion that taxpayers be encouraged to flag questionable positions on their returns but expressly declined to require disclosure of accountant's workpapers. The Senate report on TEFRA stated, *inter alia*, "the committee intends that the Secretary shall in no event require disclosure of accountant's work papers." S. Rep. No. 97-494, 97th Cong., 2d Sess. 273-74 (1982).

IV

THIS CASE IS NOT APPROPRIATE FOR REVIEW OF THE QUESTION PRESENTED

The Government's contention that certiorari is necessary because the question raised is important and "is likely to recur with frequency" (pet. 7) overlooks both the peculiar factual situation and the narrow holding of the Court below. In addition, subsequent amendments both to the Internal Revenue Code's summons enforcement provisions and to the Internal Revenue Manual make it most unlikely that the problem confronting the Court of Appeals will ever recur.

First, the Court of Appeals' approach was shaped fundamentally by its understanding of the extent to which the IRS was trying to prove fraud. There was considerable confusion as to the nature of the agreement between Amerada and the IRS and as to the Special Agent's purpose in issuing the summons. The Court's holding was predicated on the assumption that the case did "not involve allegations of fraud," 677 F.2d at 220, an assumption in all probability generated by uncertainty as to the scope of the "good-faith"

inquiry mandated by this Court's decision in *LaSalle National Bank*. *Id.* at 218. After the Court of Appeals rendered its decision, however, Congress amended the summons provisions of the Code to provide explicitly that an IRS summons may be issued for "the purpose of inquiring into any offense connected with the administration or enforcement" of the tax laws, effectively ending the uncertainty caused by *LaSalle*. Pub. L. No. 97-248, 96 Stat. 324, § 333(a), amending Internal Revenue Code § 7602(b). The Court of Appeals' analysis of the case thus responded to an uncertain factual situation that is unlikely ever to recur.

Second, the Government's contention that certiorari is necessary overlooks the narrow holding of the decision below. The qualified privilege applies only with respect to tax accrual workpapers prepared by independent auditors who are retained by publicly owned companies to assist them in complying with the federal securities laws. 677 F.2d at 217, 220-21. Further, the privilege attaches to such tax accrual workpapers only when the taxpayer's records have been produced, its accountant's audit workpapers are available, such materials contain all the factual data that the IRS needs to calculate the taxpayer's tax liability, and there is no showing of special need for the tax accrual workpapers. Finally, by limiting the privilege to cases not involving allegations of fraud, the Court below effectively restricted it to civil cases.

Substantially similar limitations on access in civil cases to independent auditor's tax accrual workpapers have been established by the IRS itself in recent revisions of its Guidelines for Requesting Audit or Tax Accrual Workpapers. *See I [Audit] Int. Rev. Man.* (CCH) § 4024.4 (May 14, 1981).* It is impossible to reconcile the petition's objections to the decision below with the position of the IRS in its revised Manual.

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* The revised section 4024.4 of the Internal Revenue Manual is included as the Appendix to this brief.

The revised IRS Manual, now in effect, requires, among other things, that before an examiner may consider requesting an independent auditor's tax accrual workpapers the examination must be substantially completed, specific issues must be identified, facts relating to the identified issues must be requested from the taxpayer, and factual analyses relating to the identified issues must be requested from the taxpayer's accountants. *Id.* at § 4024.4(2). Thereafter, if the examiner determines that a need still exists to inspect tax accrual workpapers, he must seek written approval from the Chief of the Examination Division. *Id.* at § 4024.4(5). Even then, however, the examiner's request must be "limited to those portions of the tax accrual workpapers that are material and relevant and related to the specific issue or issues identified."• *Daily Report for Executives,* DER No. 86 (BNA), May 5, 1981, at J-2 (Remarks of Comm'r R.L. Egger); *see I [Audit] Int. Rev. Man.* (CCH) § 4024.4(3) (May 14, 1981).

If these Guidelines had been in effect in 1978, a summons would not have been issued in this case, which was described by the Court below as a civil case not involving allegations of fraud. 677 F.2d at 220-21.

Finally, the decisions cited in the petition do not support the argument that the issue "is likely to recur with frequency." (pet. 7) All of those decisions were rendered before May 14, 1981, when the revisions to the Manual became effective.

• The petition is incorrect in suggesting that under the revised Manual the IRS can request an independent auditor's tax accrual workpapers "in the course of complex audits of large corporations with substantial tax liabilities." (pet. 7) The complexity of the audit, the size of the corporate taxpayer and the potential tax liability are not the determining factors under the Manual as to the IRS' authority to seek disclosure of an independent auditor's tax accrual workpapers. *I [Audit] Int. Rev. Man.* (CCH) § 4024.4 (May 14, 1981).

The "uniform national rule with respect to the production of.... tax accrual workpapers" (pet. 7) which the petition requests this Court to establish has in large part already been put into effect by the IRS. Through its new Guidelines, the IRS has eliminated the need for certiorari in this case.

CONCLUSION

The petition for a writ of certiorari should be denied.

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APPENDIX

Internal Revenue Manual § 4024.4 (May 14, 1981)

Guidelines for Requesting Audit or Tax Accrual Workpapers

(1) In unusual circumstances, access may be had to the audit or tax accrual workpapers. However, examiners should keep in mind that the taxpayer's records are the primary source of factual data to support the tax return. Accountants audit or tax accrual workpapers should normally be used only when such factual data cannot be obtained from the taxpayer's records and then only as a collateral source for factual data, access to which should be requested with discretion and not as a matter of standard examining procedure. For example, after the examiner has audited the taxpayer's records regarding the reserve for bad debts he/she may request the *audit* workpapers relating to the reserve for bad debts if those workpapers are determined to be necessary. Such a request should be made first to the taxpayer.

(2) Unusual circumstances, for this purpose exist under the following conditions:

(a) a specific issue or issues has been identified by the examiner for which there exists a need for additional facts; and

(b) the examiner has sought from the taxpayer all facts known to the taxpayer relating to the identified issue(s); and

(c) the examiner has sought from the taxpayer's accountant supplementary analysis (not necessarily contained in the workpapers) of facts relating to the identified issue(s).

(3) In any case where the unusual circumstances in (2) above furnish a basis for requesting audit or tax accrual workpapers, the examiner should limit the request only to the portion of the workpapers believed to be material and relevant to the examination. Whether an item is considered

to be "material" is based on the examiner's judgment and an evaluation of the facts and circumstances in the case. However, materiality does not depend entirely on amount. The concept involves qualitative as well as quantitative judgments. For example, the significance of an item or its impact on the tax liability could be some of the factors to be considered in making a judgment regarding materiality.

(4) The reconciliation of Schedule M-1 must be made before considering whether it is necessary to request tax accrual workpapers. Guidelines for the reconciliation are contained in text 232.8 of IRM 4233, Tax Audit Guidelines, Partnerships, Estates and Trusts, and Corporations.

(5) In situations where it is deemed necessary to request tax accrual workpapers in corporate examinations, the prior written approval of the Chief, Examination Division is required. When requesting information pertaining to the tax accrual, the examiner should first take all reasonable means to secure this information from the corporate officer before looking to the independent auditor to provide the information. This will require the examiner to question and where that is not successful to summons a financial officer or the tax manager of the corporation. See IRM 4024.5 concerning use of summons.

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In the Supreme Court of the United States

OCTOBER TERM, 1982

UNITED STATES OF AMERICA, PETITIONER

v.

ARTHUR YOUNG & COMPANY, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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QUESTION PRESENTED

Whether tax accrual workpapers, prepared by a corporation's independent certified public accountant in the course of regular financial audits, are privileged from disclosure in response to an internal revenue summons issued under 26 U.S.C. 7602.

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BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The order of the district court (Pet. App. 1a-15a) is reported at 496 F.Supp. 1152.[1] The opinion of the court of appeals (Pet. App. 16a-39a) is reported at 677 F.2d 211.

JURISDICTION

The judgment of the court of appeals was entered on April 13, 1982 (Pet. App. 40a). The order denying the government's petition for rehearing, with suggestion for rehearing en banc, was entered on June 22, 1982 (Pet.

[1] The district court issued a modified order on February 23, 1981, which was not reported and which is reproduced at J.A. 106-107.

App. 41a). By order dated September 13, 1982, Justice Marshall extended the time within which the United States might file a petition for a writ of certiorari to and including October 20, 1982, and the petition was filed on that date. The petition was granted on February 22, 1983 (J.A. 108). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

STATUTES INVOLVED

The pertinent provisions of Sections 7601, 7602 and 7604 of the Internal Revenue Code of 1954 (26 U.S.C.) are as follows:

> Sec. 7601. CANVASS OF DISTRICTS FOR TAXABLE PERSONS AND OBJECTS.
>
> (a) *General Rule.*—The Secretary shall, to the extent he deems it practicable, cause officers or employees of the Treasury Department to proceed, from time to time, through each internal revenue district and inquire after and concerning all persons therein who may be liable to pay any internal revenue tax, and all persons owning or having the care and management of any objects with respect to which any tax is imposed.
>
> Sec. 7602. EXAMINATION OF BOOKS AND WITNESSES.
>
> For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability, the Secretary is authorized—
>
> (1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry;
>
> (2) To summon the person liable for tax or required to perform the act, or any officer or

employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the Secretary may deem proper, to appear before the Secretary at a time and place named in the summons and to produce such books, papers, records, or other data, and to give such testimony, under oath, as may be relevant or material to such inquiry; and

(3) To take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry.

Sec. 7604. ENFORCEMENT OF SUMMONS.

(a) *Jurisdiction of District Court.* If any person is summoned under the internal revenue laws to appear, to testify, or to produce books, papers, records, or other data, the United States district court for the district in which such person resides or is found shall have jurisdiction by appropriate process to compel such attendance, testimony, or production of books, papers, records, or other data.

STATEMENT

1. Respondent Arthur Young & Company, a firm of certified public accountants, has served as Amerada Hess Corporation's independent auditor since November 1971. In that capacity, respondent conducted financial audits of, and certified, Amerada's financial statements for 1972 through 1974 (Pet. App. 19a). Federal securities laws require publicly-owned companies such as Amerada to file certified financial statements annually. See 15 U.S.C. 78*l* and m and 17 C.F.R. Part 210, 210.1-01, 210.1-02(a), (d) and (f), and 210.2-01 *et seq.* The certification process requires the independent auditor to evaluate the reasonableness and adequacy of the corporation's reserve for potential tax liabilities.

As part of its certification of Amerada's financial statements, respondent prepared tax accrual workpapers,

which are documents and memoranda relating to respondent's evaluation of Amerada's tax liability reserves as they appeared in its financial statements. The tax accrual workpapers include facts pertaining to Amerada's financial transactions based upon company records and respondent's interviews with company personnel and with third parties, and may identify specific items whose treatment on Amerada's tax return for the year was questionable. If the auditor determines that these items could reasonably lead to additional tax liability upon examination by the Internal Revenue Service, it will recommend the establishment of additional contingency reserves (Pet. App. 24a-25a).

In May 1975, the Internal Revenue Service began an audit to determine Amerada's corporate income tax liability for 1972 through 1974. Amerada is an integrated oil company incorporated in Delaware, and it reported gross revenues for the years under audit exceeded seven billion dollars. During the course of the audit, Amerada disclosed to the revenue agents that it had maintained a "special disbursement account," a fund from which political contributions, gifts to foreign government officials, and other illegal or questionable payments were made, and that it had convened a special committee to investigate the company's practices with respect to such payments. Amerada turned over the final report of its special committee to the Internal Revenue Service. The report disclosed the deduction of some $7,830 in questionable payments during the years in question (Pet. App. 2a-3a; *id.* at 19a).

Upon receipt of the report disclosing the deduction of questionable payments by Amerada, the Internal Revenue Service assigned Special Agent Kalemba of the Criminal Investigations Division to join the investigation. In furtherance of the joint investigation, the Special Agent issued an administrative summons to respondent pursuant to 26 U.S.C. 7602, seeking, *inter alia*, the tax accrual workpapers prepared by respondent. Pursuant to 26

U.S.C. 7609, notice of the summons was sent to Amerada, which thereupon instructed respondent not to produce any of the documents called for by the summons (Pet. App. 2a-3a; *id.* at 19a-20a).

On October 9, 1979, the government commenced this proceeding to enforce the summons in the United States District Court for the Southern District of New York.[2] Pursuant to 26 U.S.C. 7609, Amerada intervened in the proceeding. Both Amerada and respondent filed answers to the petition opposing enforcement of the summons, objecting, *inter alia*, to the production of the tax accrual workpapers (Pet. App. 3a; *id.* at 18a).

The district court ordered production of the tax accrual workpapers. It found that the documents were relevant to the Internal Revenue Service's tax investigation of Amerada and rejected respondent's claim of an accountant-client privilege. The district court noted that this Court had refused to recognize such a privilege in *Couch* v. *United States*, 409 U.S. 322, 335-336 (1973), and that the First Circuit adhered to that view, even where the client claimed that it gave the information to the auditor under an expectation of privacy. See *United States* v. *Arthur Andersen & Co.*, 623 F.2d 725, 728

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[2] In support of its petition for enforcement of the summons, the government submitted an affidavit by Special Agent Armstrong, who had succeeded Special Agent Kalemba. In his affidavit, the agent stated, *inter alia*, that the summons had been issued in the course of a joint investigation by the Examination and Criminal Investigation Divisions of the Internal Revenue Service to ascertain the correctness of Amerada's tax returns for the years 1972, 1973 and 1974; that no decision or recommendation had been made regarding criminal prosecution of Amerada; and that the material sought was relevant to the purpose of the examination and was not in the government's possession (J.A. 11-14). Subsequently, there were repeated exchanges of affidavits between IRS officials, on the one hand, and Arthur Young and Amerada, on the other, in which Arthur Young and Amerada disputed the accuracy of the IRS agent's affidavit (J.A. 22-79). This factual dispute led to a hearing before the district court on January 3, 1980 (J.A. 80-88). After considering the conflicting affidavits, the district court enforced the summons with respect to the tax accrual workpapers.

(1980). As the district court concluded, "While there may be an expectation of privacy insofar as the world at large is concerned, Amerada cannot reasonably have such an expectation [of privacy] with regard to the IRS which, the taxpayer knew, could call for all materials underlying the tax returns and payments" (Pet. App. 9a).

2. A divided panel of the court of appeals reversed the district court's order with respect to the tax accrual workpapers (Pet. App. 28a-32a).[3] The court agreed with the district court's finding that tax accrual workpapers were relevant to the Internal Revenue Service's audit of Amerada's tax liability (*id.* at 24a-27a). The court nevertheless refused to enforce the summons because of its belief that "these documents should remain confidential in order to protect the reliability of the independent audit process" (*id.* at 19a).

In support of its decision, the court of appeals expressed the view that the policies behind the disclosure requirements of the federal securities laws outweigh the policies

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[3] The Internal Revenue Service's summons directed respondent to produce all files related to its client, Amerada Hess Corporation, for which respondent served as independent auditor (Pet. App. 17a-18a, 20a n.4). The district court ordered the production of all items sought by the summons except respondent's audit program and the documents prepared by the special committee that investigated Amerada's questionable payments. The government did not appeal the district court's refusal to enforce the summons with respect to the audit program and the special committee documents.

Accordingly, the only issues considered by the court of appeals were the production of audit workpapers and tax accrual workpapers (Pet. App. 20a-21a). Since the court of appeals affirmed the district court's order with respect to the audit workpapers (*id.* at 21a-24a), the government's petition to this Court was limited to the tax accrual workpapers. Although Arthur Young has sought to raise the question of the production of the audit workpapers in its cross-petition (No. 82-837), the Court has not granted that cross-petition, which remains pending. Hence, the only question before this Court is that presented by the government's petition, *i.e.*, the production of the tax accrual workpapers.

in support of the Internal Revenue Service's summons authority. As the court reasoned, these "countervailing policies" "require[d] * * * [it] to fashion protection for the work that independent auditors, retained by publicly-owned companies to comply with the federal securities laws, put into preparation of tax accrual workpapers" (Pet. App. 28a). The court apparently assumed that the tax accrual workpapers contain material with respect to the "thoughts and theories" (*id.* at 31a) of the taxpayer and its auditor concerning potential tax liabilities, and their strategies and plans for negotiations about these liabilities. It stated that "the Service does not need to know the taxpayer's thoughts," and that the IRS can obtain "all the raw data" needed to calculate the taxpayer's tax from other sources (*ibid.*). The court feared that if the summons were enforceable, corporate management "might not be perfectly candid with independent auditors" once it knew that such information would be reachable under § 7602 (*id.* at 30a). The court concluded that enforcement would therefore handicap investors, who must rely on independent auditors for financial information regarding publicly-traded securities (Pet. App. 31a).

In reaching its decision, the court relied on the attorney's work-product doctrine of *Hickman* v. *Taylor*, 329 U.S. 495 (1947). Its reasoning, however, was based primarily on an asserted need to encourage confidential client-accountant communications—that is, on the need to create an accountant's communications privilege. The court concluded that the IRS may not obtain tax accrual workpapers except in the "rare situation * * * where it [the IRS] can make a sufficient showing of need to adequately justify invading the integrity of the auditing process" (Pet. App. 31a). No such showing, according to the court, had been made here, since all the relevant data were available to the IRS outside the tax accrual workpapers (*id.* at 32a).

The dissenting judge would have enforced the summons (Pet. App. 33a-39a). He believed that Congress had leg-

islated in favor of disclosure of all relevant documents not subject to traditional common law privileges, which do not include a privilege for either client communications to an accountant or an accountant's work-product. The dissent observed that "[i]f there is to be recognition of new privileges, we should leave that task to Congress" (*id.* at 35a). The dissent found nothing in the language or the legislative history of Section 7602 to indicate that Congress intended to exempt an accountant's work-product from Internal Revenue Service examination. Nor could he find anything in *Hickman* v. *Taylor*, or the Federal Rules of Civil Procedure, that would permit a court to depart from the broad command of Section 7602 (Pet. App. 36a-37a). As the dissent pointed out, there is no proper analogy between the attorney-client relationship and the relationship between a public corporation and its independent public accountant. The attorney-client relationship is completely private and cloaked in confidence. On the other hand, an independent public accounting firm has public obligations to assure itself that contingent tax liabilities have been accurately reflected, and must decline to certify a statement if it is not satisfied that it is accurate (*id.* at 37a-38a).

The dissenting judge also rejected the majority's premise that corporations would be so anxious to minimize their tax payments that they would be willing to deceive their own accountants about debatable tax items and thereby violate their obligations under the securities law. He doubted "that many corporations will be so anxious to avoid that result [paying what the tax laws require] that they will conceal these debatable items from their accountants in violation of the securities laws" (Pet. App. 36a). But even on the assumption that the majority's speculation was accurate, the dissent concluded that the courts should not afford publicly-held corporations "any shield behind which they can increase their

chances of avoiding detection that they have not paid either the amount of taxes a court might rule was lawfully required or whatever adjustment might result from a post-audit settlement" (*ibid.*).

SUMMARY OF ARGUMENT

1. In refusing to enforce an Internal Revenue Service summons directing a certified public accountant to produce tax accrual workpapers prepared in connection with its regular financial audits of a publicly held corporation and its certification of the corporation's financial statements, the decision below has created an accountant work-product privilege, under the rationale of an accountant-client privilege, that threatens to impede the Internal Revenue Service's tax investigations of public corporations. The case therefore stands in derogation of this Court's ruling in *Couch* v. *United States*, 409 U.S. 322, 335 (1973), that "no confidential accountant-client privilege exists under federal law, and no state-created privilege has been recognized in federal cases * * *."

As the Court most recently reaffirmed in *Trammel* v. *United States*, 445 U.S. 40, 50 (1980), quoting *United States* v. *Bryan*, 339 U.S. 323, 331 (1950), any claim of privilege must overcome the settled principle that " 'the public * * * has a right to every man's evidence.' " Because testimonial privileges preclude the use of highly relevant evidence and therefore tend to be "an obstacle to the administration of justice" (8 J. Wigmore, *Wigmore on Evidence* § 2192, at 73 (McNaughton rev. ed. 1961); see *United States* v. *Nixon*, 418 U.S. 683, 711-713 (1974)), such privileges are tolerable only when they "are designed to protect weighty and legitimate competing interests" (*id.* at 709).

These considerations are fully applicable to the summons authority of the Internal Revenue Service. Section 7602 of the 1954 Code, authorizes the Secretary "[t]o summon * * * any * * * person * * * to appear * * * and to produce such books, papers, records, or other data * * * as may be relevant or material" to ascertaining the

correctness of any return. This Court has consistently construed this authority to embrace all appropriate measures for enforcement. See, *e.g.*, *United States* v. *Powell*, 379 U.S. 48 (1964); *Donaldson* v. *United States*, 400 U.S. 517 (1971); *United States* v. *Bisceglia*, 420 U.S. 141 (1975); *United States* v. *Euge*, 444 U.S. 707 (1980).

2. Both courts below found that the tax accrual workpapers sought from respondent were relevant to the Internal Revenue Service's investigation of Amerada (Pet. App. 8a; Pet. App. 26a-27a). These papers consist of an amalgam of materials bearing on the adequacy and reasonableness of the contingency reserves established by a corporation with respect to its tax liabilities. The papers contain facts that may not appear on the corporation's books of account. They may also shed important light on the taxpayer's state of mind regarding the treatment it ultimately presents on its tax returns; this evidence may bear on liability for fraud and other penalties. Finally, the papers may also contain the accountant's judgments regarding the corporation's reporting positions.

The purpose of obtaining tax accrual workpapers is not primarily to allow the Service access to the accountant's "opinions" and "theories". Rather, the Service's chief interest is to discover the relevant facts to enable it to make its own appraisal. Although production of these papers may help the investigating agent by highlighting certain issues, there is no basis for cloaking them in secrecy in the absence of an evidentiary privilege barring their production.

3. The court erred in barring production of the tax accrual workpapers on the authority of the attorney work-product doctrine established by this Court's decision in *Hickman* v. *Taylor*, 329 U.S. 495 (1947). In *Hickman*, the Court recognized a qualified privilege against pretrial discovery for certain materials prepared by an attorney "acting for his client in anticipation of litigation" (329 U.S. at 508). See *United States* v. *Nobles*, 422 U.S. 225, 236-240 (1975); *Upjohn Co.* v. *United*

States, 449 U.S. 383, 397-399 (1981). Here the papers were prepared by accountants—not by attorneys—in the course of a regular audit of financial statements—and not in anticipation of litigation. Apart from the decision below, we are aware of no case that extends the attorney work-product rationale to accountants' work-papers.

The law recognizes an attorney work-product privilege and not an accountant work-product privilege because of important practical differences between the function of an accountant and that of an attorney. The attorney is the client's confidential advisor who has an obligation of undivided loyalty to the client. An independent certified public accountant, as the title states, is supposed to be independent: its loyalty is not only to the client whose books it is auditing but also to various governmental agencies regulating its client's industry, to his client's creditors and to investors in its client's securities. Further, the accountant's role is not to give confidential advice but to give *public* reports on the adequacy of the client's financial statements. It was precisely these differences between accountants and attorneys that this Court recognized in *Couch* in rejecting the claim of an accountant-client privilege as to a taxpayer's records turned over to an accountant. See 409 U.S. at 335-336.

4. Although the decision below is couched in terms of the work-product privilege, it is plain that the court believed it was fostering candid communications between client and accountant for the benefit of the investing public and the enforcement of the securities laws. Such a rationale is the essence of a communications privilege.

The fundamental distinctions between attorneys and accountants, to which we have referred, have led this Court, and every court that has considered the issue, to reject the creation of an accountant-client privilege. *Couch* v. *United States*, *supra*, 409 U.S. at 335-336, and cases cited therein. An accountant's client has no justified expectation of confidentiality with respect to communica-

tions with an accountant, and there is therefore no justification for the creation of an accountant-client privilege.

Moreover, the rationale for such a privilege does not exist in this case. The principal contemporary justification for the attorney-client privilege is its presumed value in encouraging clients to make full disclosure to their attorneys. *Upjohn Co.* v. *United States*, *supra*, 449 U.S. at 389; 8 J. Wigmore, *supra*, §§ 2291 and 2306, at 590. Accordingly, it protects only those disclosures—necessary to obtain legal advice—which might not have been made absent the privilege. *Fisher* v. *United States*, 425 U.S. 391, 403 (1976). But the communications from Amerada to respondent in this case were required to be made quite apart from any accountant-client privilege. As a publicly-held corporation, Amerada must file accurate and complete financial statements, certified by its independent auditors, with the SEC, if it wishes to continue to have its stock publicly traded. See 15 U.S.C. 78*l* and m; 17 C.F.R. 210.1-02(d).

5. The court of appeals further erred in assuming a conflict between the federal statutes regulating securities and those enforcing revenue collection. Section 7602 of the 1954 Code unequivocally authorizes agents of the Internal Revenue Service to summon and inspect records that may be relevant to their investigation. On the other hand, the securities regulations relate to the duty of listed corporations to file annual audited statements, and the duty of auditors to examine the statements under generally accepted principles of public accounting. The statutes and regulations do not even hint at any duty by the accountants to keep their clients' communications confidential. It would therefore be incongruous to enjoin accountants to do so—particularly since their basic function is to insure that the public is accurately informed.

As the Court made clear in *St. Regis Paper Co.* v. *United States*, 368 U.S. 208 (1961), it requires a clear statement of congressional purpose to create a special rule that will prevent disclosure of information otherwise

relevant and unprivileged. In *St. Regis Paper Co.* the Court held that Section 9(a) of the Census Act (13 U.S.C. (1958 ed.) 9(a)) preventing the Census Bureau from disclosing census information except in the form of statistical reports, did not curtail the normal investigatory powers of other government agencies. The present case follows a fortiori from *St. Regis Paper Co.*, since the securities laws and regulations do not contain any requirements of confidentiality for accountants.

Even assuming that the court below correctly identified a conflict between the policies underlying the securities laws and the provisions regarding tax enforcement, the resolution of such a conflict lies with Congress and not in the courts. This is particularly true where, as here, the securities laws provide no explicit defense to an Internal Revenue Service summons and a literal reading of the revenue provision directs that the documents be produced. There is no justification for the conclusion that the securities law has somehow repealed or cut back on the scope of the Internal Revenue Service's summons authority.

ARGUMENT

TAX ACCRUAL WORKPAPERS PREPARED BY A CORPORATION'S INDEPENDENT CERTIFIED PUBLIC ACCOUNTANT IN THE COURSE OF REGULAR FINANCIAL AUDITS ARE SUBJECT TO PRODUCTION IN RESPONSE TO AN INTERNAL REVENUE SUMMONS ISSUED UNDER 26 U.S.C. 7602

This case presents a question of great importance to the enforcement of the internal revenue laws against corporations that engage certified public accountants. In refusing to enforce an Internal Revenue summons directing a certified public accountant to produce tax accrual workpapers prepared in connection with its regular financial audits of a publicly-held corporation and its certification of the corporation's financial statements, the court of appeals has created an accountant work-product privilege, which it justified by the rationale of an

accountant-client communications privilege. Its holding threatens to impede the Internal Revenue Service's tax investigations of public corporations. The decision below therefore stands in derogation of this Court's ruling in *Couch* v. *United States*, 409 U.S. 322, 335 (1973), that "no confidential accountant-client privilege exists under federal law, and no state-created privilege has been recognized in federal cases * * *."

Moreover, the significance of the privilege created by the court below is not limited to IRS summons enforcement proceedings. The existence of such a privilege would be relevant to many other disputes between federal agencies and corporations, as well as to the conduct of a grand jury investigation. Indeed, the court of appeals' desire to promote candor between accountant and client could not rationally be limited to questionable transactions having tax significance; it would necessarily extend to transactions questionable by other criteria as well. Even more important, recognizing such a privilege would radically affect private litigation involving corporations.

As we shall discuss in greater detail (pp. 24-27, *infra*), the tax accrual workpapers at issue in this case record the result of the auditor's inquiry with respect to the adequacy of a public corporation's reserve for contingent tax liabilities under generally accepted accounting standards. They include factual information obtained by the auditor from the taxpayer and others with respect to financial transactions, as well as the auditor's analyses of these transactions and its evaluation of the correctness of the various reporting positions taken on the corporation's tax return. Accordingly, they are relevant to a legitimate tax investigation. Although the Internal Revenue Service does not routinely seek these accountants' workpapers,[4] it does request them where necessary fac-

[4] The Internal Revenue Manual instructs agents that before requesting information pertaining to the tax accrual account, they should "first exhaust all reasonable means to secure this information from the corporate officer before looking to the independent auditor to provide the information." *Guidelines for Requesting*

tual data pertinent to a corporation's tax liability cannot be obtained from the taxpayer's books of account. Tax accrual workpapers therefore constitute a valuable source of relevant evidence in determining the tax liabilities of the nation's largest corporations.

The refusal of the court below to enforce the summons on the ground of a purported privilege it found to exist for accountants' tax accrual workpapers is contrary to the well-established rule that "[e]videntiary privileges in litigation are not favored." *Herbert* v. *Lando*, 441 U.S. 153, 175 (1979). Indeed, as the Court reaffirmed in *Trammel* v. *United States*, 445 U.S. 40, 50 (1980), quoting *United States* v. *Bryan*, 339 U.S. 323, 331 (1950), any claim of privilege must overcome the settled principle that "the public * * * has a right to every man's evidence.'" Accord: *Branzburg* v. *Hayes*, 408 U.S. 665, 688 (1972). "Whatever their origins, these exceptions to the demand for every man's evidence are not lightly created nor expansively construed, for they are in derogation of the search for truth." *United States* v. *Nixon*, 418 U.S. 683, 710 (1974). See also *Blackmer* v. *United States*, 284 U.S. 421, 438 (1932); 8 J. Wigmore, *supra*, § 2192, at 73. Because testimonial privileges hide relevant evidence and therefore tend to be "an obstacle to the administration of justice" (*id.* § 2192, at 73; see *United States* v. *Nixon*, *supra*, 418 U.S. at 711-713), such privileges are tolerable only when they "are designed to protect weighty and legitimate competing interests" (*id.* at 709). See also *Elkins* v. *United States*, 364 U.S. 206, 234 (1960) (Frankfurter, J., dissenting).

These considerations are fully applicable to the summons authority of the Internal Revenue Service. Our self-reporting tax system is premised upon the assumption that the majority of taxpayers will honestly report their income and deductions. But Congress has long recognized that if the Treasury is to discharge effectively

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Audit or Tax Accrual Workpapers, [Audit] 1 Int. Rev. Man. (CCH) ¶ 4024.4 (May 14, 1981).

its duty to administer and enforce the internal revenue laws (26 U.S.C. 7801), it must have the statutory power to obtain information with respect to persons who may not have complied with the tax laws.

A. Congress has given the Internal Revenue Service authority to obtain information relevant to its tax investigations

1. Sections 7601 and 7602 of the 1954 Internal Revenue Code (26 U.S.C.) (pp. 2-3, *supra*) provide the Treasury with the authority necessary to support vigorous and searching investigations of taxpayers' liabilities for tax. The former provision imposes upon the Secretary the duty "to proceed * * * and inquire after and concerning all persons * * * who may be liable to pay any internal revenue tax." "[T]he section thus flatly imposes upon the Secretary the duty to canvass and to inquire" *Donaldson* v. *United States*, 400 U.S. 517, 523-524 (1971). Section 7602 empowers the Secretary to require the submission of records and testimony for that purpose. It authorizes the Secretary "[t]o summon * * * any * * * person * * * to appear * * * and to produce such books, papers, records, or other data * * * as may be relevant or material" to ascertaining the correctness of any return. "The purpose of the statutes is not to accuse, but to inquire. Although such investigations unquestionably involve some invasion of privacy, they are essential to our self-reporting system, and the alternatives could well involve far less agreeable invasions of house, business, and records." *United States* v. *Bisceglia*, 420 U.S. 141, 146 (1975).

Section 7602 is the Treasury's principal information-gathering authority, and this Court has construed it broadly to achieve its purpose—effective investigations. Thus the Court has frequently analogized the summons power to the common law duty attaching to the issuance of a testimonial summons. See *United States* v. *Bisceglia*, *supra*, 420 U.S. at 147-148; *United States* v. *Powell*, 379 U.S. 48, 57 (1964). This common law duty has been ex-

pansively construed and is normally limited only by notions of relevance and by certain well cabined doctrines of privilege. See, *e.g.*, *Blair* v. *United States*, 250 U.S. 273 (1919); *United States* v. *Bryan*, *supra*, 339 U.S. at 331. Although the Court has recognized that there may be exemptions from the public duty to give evidence to a competent authority, the "primary assumption" is that a summoned party must "give what testimony one is capable of giving" absent an exemption "grounded in a substantial individual interest which has been found, through centuries of experience, to outweigh the public interest in the search for truth" (*ibid.*).

Moreover, the Court has consistently construed the summons authority Congress conferred in Section 7602 to embrace all appropriate measures for enforcement, repeatedly rejecting attempts to circumscribe the effective exercise of the Internal Revenue summons power. The Court has upheld summons for tax-related accountant's workpapers, whether in the possession of the taxpayer's accountant (*Couch* v. *United States*, *supra*) or the taxpayer's attorney (*Fisher* v. *United States*, 425 U.S. 391 (1976)). See also *United States* v. *Powell*, *supra*, 379 U.S. at 57; *United States* v. *Bisceglia*, *supra*; and *United States* v. *Euge*, 444 U.S. 707 (1980). "There is thus a formidable line of precedent construing congressional intent to uphold the claimed enforcement authority of the Service if authority is necessary for the effective enforcement of the revenue laws and is not undercut by contrary legislative purposes" (444 U.S. at 715-716; footnote omitted). An Internal Revenue Service summons to produce evidence relevant to a legitimate investigation is enforceable unless an established privilege protects such evidence or there are "unambiguous directions from Congress" to the contrary. *United States* v. *Bisceglia*, *supra*, 420 U.S. at 150.

2. As the Court observed in *Donaldson* v. *United States*, *supra*, 400 U.S. at 535, the history of Section 7602 confirms our submission that the statute authorizes the use of a summons to compel the production of documents prepared by an accountant that may be material

in determining tax liability.[5] The statutory history shows that the summons power was derived from Sections 3614, 3615(a)-(c), and 3654 of the Internal Revenue Code of 1939 (see Table II to 1954 Code, 68A Stat. 969) and that these three provisions had independent roots in revenue acts dating back to 1919, 1864, and 1868, respectively. These three sections of the 1939 Code are highly significant because, in adopting Section 7602, Congress intended "no material change from existing law." H.R. Rep. No. 1337, 83d Cong., 2d Sess. A436 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 617 (1954). See also H.R. Rep. No. 1337, *supra*, at 99; S. Rep. No. 1622, *supra*, at 133; 100 Cong. Rec. 3425 (1954).

Section 3614(a) of the 1939 Code authorized the Commissioner "to examine any books, papers, records, or memoranda bearing upon the matters required to be included in the return, and [to require] * * *the attendance of any other person having knowledge in the premises, and [to] take his testimony with reference to the matter required by law to be included in such return * * * ."[6]

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[5] The tax accrual workpapers prepared by respondent fit comfortably within the statutory phrase "any books, papers, records, or other data * * *." Section 7602(1). Moreover, the statutory summons power of the Internal Revenue Service unquestionably extends to accountants who are or may have been engaged by the taxpayer. Section 7602(2) broadly authorizes the Service to summon "any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax * * *, or any other person the Secretary may deem proper, to appear * * * and to produce such books, papers, records, or other data, and to give such testimony, under oath, as may be relevant or material to such inquiry * * *."

[6] The Commissioner was first given the power to examine records and compel attendance of witnesses and take testimony in 1919. Act of Feb. 24, 1919, ch. 18, Section 1305, 40 Stat. 1142. As evidenced by Section 3654 of the 1939 Code, which had its origins in 1868 (pp. 19-20 n.8, *infra*), similar authority had been previously granted to the collectors. This authority was likewise continued.

The 1919 provision was reenacted several times before becoming part of the 1939 Code. Act of Nov. 23, 1921, ch. 136, Section

Section 3615(a) empowered the collector to "summon any person to appear * * * and to produce books * * *, and to give testimony or answer interrogatories * * * respecting any objects or income liable to tax or the returns thereof * * *." Section 3615(c)(2) and (3) extended the summons power to "any other person having possession, custody, or care of books of account containing entries relating to the business of any person * * *" or "[a]ny other person the collector may deem proper."[7] Finally, the third source for the present summons authority—Section 3654(a) of the 1939 Code—conferred upon the collectors the "power to examine all persons, * * * books and papers, accounts, and premises, to administer oaths, and to summon any person to produce books and papers, or to appear and testify under oath before him * * *."[8]

1308, 42 Stat. 310; Act of June 2, 1924, ch. 234, Section 1004, 43 Stat. 340; Act of Feb. 26, 1926, ch. 27, Section 1104, 44 Stat. 113; Act of May 29, 1928, ch. 852, Section 618, 45 Stat. 878.

[7] Section 3615(a)-(c) of the 1939 Code closely followed a provision first adopted in 1864, Act of June 30, 1864, Section 14, 13 Stat. 226, and reenacted several times prior to its codification in 1939. Act of July 13, 1866, ch. 184, Section 9, 14 Stat. 101; Act of Dec. 24, 1872, ch. 13, Section 1, 17 Stat. 401. In 1874, the provision was codified as part of Section 3173 of the Revised Statutes (1878 ed.), which was amended by Act of Mar. 1, 1879, ch. 125, Section 3, 20 Stat. 330-331, Act of Aug. 27, 1894, ch. 16, Section 34, 28 Stat. 557; Act of Oct. 3, 1913, ch. 16, Subsec. I, 38 Stat. 177; Act of Sept. 8, 1916, ch. 463, Section 16, 39 Stat. 773; Act of Feb. 24, 1919, ch. 18, Section 1317, 40 Stat. 1146; Act of Nov. 23, 1921, ch. 136, Section 1311, 42 Stat. 311; Act of June 2, 1924, ch. 234, Section 1018, 43 Stat. 344; Act of Feb. 26, 1926, ch. 27, Section 1115, 44 Stat. 117.

[8] Section 3654 of the 1939 Code was derived from an essentially identical provision first enacted in 1868, Act of July 20, 1868, ch. 186, Section 49, 15 Stat. 144, and codified as part of Section 3163 of the Revised Statutes of 1874 (1878 ed.).

Table II of the 1954 Code, 68A Stat. 969, states that Sections 3614 and 3615(a)-(c) of the 1939 Code were essentially carried forward into Section 7602 of the 1954 Code. See also *Donaldson* v. *United States*, *supra*, 400 U.S. at 535. Although Table II does not

By combining Sections 3614, 3615 and 3654 into Section 7602 in 1954 without intending to change existing law, Congress affirmed the use of an Internal Revenue summons to compel the appearance and testimony of all persons who could further an investigation leading to the discovery of all those who may be liable for unpaid taxes. Like Section 7602, the prior provisions defined the summons power in the broadest possible manner, using terms such as "books, papers, records, or memoranda bearing upon the matters required to be included in the return"; "require the attendance of any * * * person having knowledge in the premises"; "to summons any person to appear * * * to give testimony or answer interrogatories," and "to examine all persons, books, papers, accounts, and premises."

3. Thus, the history as well as the text, of both the current provision and its authoritative predecessors, confirm the correctness of this Court's statement in *United States* v. *Euge*, *supra*, 444 U.S. at 712, that the testimonial requirement imposed by Section 7602 is "an expansive duty limited principally by relevance and privilege."[9] Here, both courts below found that the tax ac-

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contain a reference to Section 3654(a) of the 1939 Code, that provision is likewise necessary as an aid to understanding the current scope of the summons power because of Congress' stated intention not to change existing law. Moreover, there was no need to continue the summons authority to collectors because the office of collector had been abolished (26 U.S.C. 7804). Pursuant to Sections 7801 and 7802 of the 1954 Code, the authority to enforce the revenue laws was vested in the Secretary of the Treasury and the Commissioner of Internal Revenue.

[9] For purposes of this case, the other requirements for enforcement of an Internal Revenue Service summons have been met and are not at issue. Thus, the Internal Revenue Service must demonstrate that the investigation is conducted for a legitimate purpose, the information sought may be relevant and is not already in the Internal Revenue Service's possession, and the administrative steps prescribed by the Internal Revenue Code have been followed. *United States* v. *Powell*, *supra*, 379 U.S. at 57-58. In practice, these re-

crual workpapers sought from respondent were "relevant" to the inquiry the IRS was conducting under Section 7602. The plain language of Section 7602 thus requires the courts to uphold the summons to produce them. The court of appeals nevertheless refused to order production on the unprecedented ground that the "integrity of the auditing process" requires that a "privilege be carved out" (Pet. App. 31a) insulating these papers from summons in the absence of some extraordinary showing of need.

As we shall show, the creation of this new privilege was unwarranted, and rested on significant errors in the court's analysis. However, before we turn to a detailed discussion of the decision below and to the question of privilege, we deem it important to describe the nature and contents of tax accrual workpapers of the sort at issue in this case. An understanding of the character of such papers will confirm that they are not only fully relevant —as the courts below correctly acknowledged—but also that they should not be insulated from disclosure by a newly-invented evidentiary privilege.

B. Tax accrual workpapers contain evidence that is unquestionably relevant to the Internal Revenue Service's tax investigations

1. Every publicly-held corporation engages independent auditors who are qualified as certified public accountants to conduct regular financial audits of its books and to certify its financial statements. These regular financial audits generate audit workpapers and tax accrual workpapers. As the court of appeals observed with respect to the first category of documents referred to as audit workpapers, these papers "consist almost entirely of factual

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quirements are met by an affidavit from the agent issuing the summons, which states that the investigation has civil purposes and that the summons was issued prior to a recommendation for criminal prosecution, and further recites that the other requirements prescribed by *Powell* have been met.

data generated from the books when accountants verify the financial statements prepared by Amerada's own personnel by spot-checking selected bookkeeping entries and records" (Pet. App. 21a). The court further added that these audit workpapers "include third-party confirmations of transactions, as well as the auditor's own judgments about the implications of the company's transactions. Some of the workpapers contain material learned during confidential discussions between Amerada and [Arthur Young] employees" (*ibid.*).

But the fact that the audit workpapers contained information that was treated as confidential between Amerada and its outside auditor did not put such documents beyond the reach of the Internal Revenue summons. In enforcing the summons requiring the production of the audit workpapers, the court of appeals concluded that "it is clear that the audit workpapers pass the *Powell* test" (Pet. App. 23a). In so ruling, it relied upon its prior ruling in *United States* v. *Noall*, 587 F.2d 123 (2d Cir. 1978), cert. denied, 441 U.S. 923 (1979), enforcing a summons to produce internal audit workpapers. Finding no meaningful distinction between the internal audit workpapers in *Noall* and the external audit workpapers at issue in this case, the court reaffirmed its statement in *Noall* that "the purposes of the internal audit include the detection of overstatements or understatements of revenues or expenses, and of identifying accounting procedures that would lead to these. If the internal auditors have ascertained an understatement of revenues or an overstatement of expenses, this plainly might throw light on the correctness of the returns" (587 F.2d at 126).

2. The court of appeals' observations with respect to the relevance of the audit workpapers are equally applicable to the tax accrual workpapers whose production it refused to order. The tax accrual account (also known as the tax pool analysis, the noncurrent tax account, or the tax pool) is a reserve account that appears on the liability side of the corporate balance sheet. This account

reflects the sum of contingent tax liabilities relating to the tax treatment of transactions occurring in prior years that may give rise to possible, but not agreed to, adjustments in the corporation's tax liabilities for those years. E. Kohler, *A Dictionary for Accountants* 119-120 (5th ed. 1975). See also G. Johnson & J. Gentry, *Finney and Miller's Principles of Accounting (Intermediate)* 117-118 (7th ed. 1974). The purpose of the accountant's examination of the account is to determine the adequacy and reasonableness of that reserve. N. Lenheart & P. Defliese, *Montgomery's Auditing* 508 (8th ed. 1957).

Both courts below correctly concluded that respondent's tax accrual workpapers were relevant to the Service's investigation of Amerada (Pet. App. 6a-8a; *id.* at 27a).[10] As the court of appeals observed, "we have consistently used as our test of relevance whether the documents requested 'might have thrown light upon' the correctness of a return" [citations omitted]. The documents at issue here certainly pass this low threshold of relevance. Different tax positions lead to different amounts of liability. It is difficult to say that the assessment by the independent auditor of the correctness of positions taken by the tax-

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[10] Both courts below rejected respondent's arguments that (1) only documents actually used in the preparation of federal income tax returns are relevant, and (2) documents sought from any third party are subject to an even higher threshold of relevance. In so holding, they relied on *United States* v. *Noall*, 587 F.2d 123 (2d Cir. 1978), cert. denied, 441 U.S. 923 (1979), which ruled that even documents not used in tax return preparation may, nevertheless, be relevant to an Internal Revenue Service audit as long as the documents might throw some light on the correctness of the return. *Id.* at 125. But cf. *United States* v. *Coopers & Lybrand*, 413 F. Supp. 942 (D. Colo. 1975), aff'd, 550 F.2d 615 (10th Cir. 1977). See p. 39 n.23, *infra*. The court of appeals further held that even assuming that a higher threshold of relevance might apply to records in the hands of a third party who was in fact a stranger to the taxpayer, respondent could not claim protection under such a rule because it had been and continued to be intimately involved in Amerada's financial and tax affairs (Pet. App. 22a).

payer in his return would not throw 'light upon' the correctness of the return" (*id.* at 27a).[11]

3. As the name implies, tax accrual workpapers consist of an amalgam of various sorts of materials bearing on the adequacy and reasonableness of the contingency reserves established by a corporation with respect to its tax liabilities.

(a) These papers will, of course, contain or refer to large bodies of factual information about the corporation's financial transactions that are relevant to its tax liabilities. The data will come not only from the corporation's books but also from information gathered from the corporation s employees and from third parties.

Some of these data may in fact be readily available on an ordinary audit of the corporation's books. But not necessarily all of it. The data may include facts that do not appear on the taxpayer's returns or the supporting schedules or attachments and that may not come to the attention of the IRS during a normal audit of the taxpayer's books. For example, a multinational corporate client may provide its accountant with facts about the income, expenses, and level of bona fide business activity of an off-shore subsidiary that the client does not include in its tax return. An appraisal of the facts may suggest the necessity for the Commissioner to make pricing adjustments under Section 482, the existence of Subpart F (Sections 952 *et seq.*) income, or other adjustments that may require assessment of additional taxes against the U.S. parent. These are typical and frequently arising issues in a multinational corporate tax audit. And these facts may very well not be readily available on a routine IRS audit; if discovered, they may, however, cast serious doubt on the propriety of the decision not to report, and may lead the independent auditor to recom-

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[11] "The statutory language [of Section 7602(2)] is 'may be relevant or material.' Congress acted advisedly in using the verb 'may be' rather than 'is,' since the Commissioner cannot be certain that the documents are relevant or material until he sees them." *United States* v. *Noall*, *supra*, 587 F.2d at 125.

mend the establishment of a tax reserve against the contingency that the facts will be uncovered and additional taxable income and deficiencies determined.

(b) The tax accrual workpapers may also shed important light on the taxpayer's state of mind regarding the treatment it ultimately presents on its tax returns. If the taxpayer chooses to disregard the accountant's opinion that the Code and Regulations require an item to be reported in a certain manner and presents the transaction in a way likely to mislead the Internal Revenue Service, the taxpayer runs the risk of being held liable for the penalty provided by Section 6653(a) of the 1954 Code for "intentional disregard of rules and regulations" and may also be liable for an additional fraud penalty.[12] 26 U.S.C. 6653(b). Thus, the accountant's appraisal may bear on the taxpayer's liabilities for these penalties.[13]

(c) Furthermore, as any sophisticated lawyer or accountant knows, there is a vast difference between "raw" data and "organized" data. The *point* of the tax accrual workpaper process is to organize the facts; the papers

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[12] The court of appeals apparently believed that tax accrual workpapers should be protected "so long as a case does not involve allegations of fraud" (Pet. App. 31a). But as this Court recognized in *United States* v. *LaSalle National Bank*, *supra*, 437 U.S. at 308-309, the purpose of a tax investigation is to determine all relevant facts that may establish a basis for additional taxes, the imposition of the fraud penalty, or even criminal prosecution. Most cases begin as routine audits, not as fraud investigations. Hence, Section 7602 necessarily permits the use of a summons at the very outset of the investigation for the purpose of uncovering the basic facts necessary for a determination of the taxpayer's correct liability, including liability for the fraud penalty.

[13] The 1982 amendments to the Internal Revenue Code of 1954 (to be codified in 26 U.S.C.) added additional penalties that make the taxpayer's state of mind even more relevant to an income tax investigation. See Pub. L. No. 97-34, 95 Stat. 341 (Section 6659) (Addition to Tax in the Case of Valuation Overstatements); Pub. L. No. 97-248, 96 Stat. 324 (Section 6661 (Substantial Understatement of Liability); Section 6700 (Promoting Abusive Tax Shelters); and Section 6701 (Penalties for Aiding and Abetting Understatement of Tax Liability).

will in effect embody the taxpayer's and the accountant's judgments about which facts are *relevant* to the taxpayer's lawful tax liability.

In the case of a taxpayer with billions of dollars of revenues arising from untold numbers of intricate transactions, the integrity of a self-reporting tax system comes under special strain. The fact that a needle is there, present in the haystack, is not enough—the summons authority extends as well to available tools for discovering it. And since it is the taxpayer's duty to report the needle in its return, and the accountant's duty to discover whether there may be unreported needles, their judgments about what constitutes a needle—about which facts are relevant to the taxpayer's lawful tax liabilities—are not entitled to be cloaked in secrecy.

It is in this sense that tax accrual workpapers may be characterized as a roadmap (to use the figure employed by the court of appeals (Pet. App. 31a))—a roadmap through the raw data. They organize the terrain under standards of relevance derived from the necessity to certify the taxpayer's financial statements. And the fact that the roadmap has been created by the taxpayer and the accountant—rather than the IRS itself—does not meaningfully distinguish it from other data amenable to summons or justify enshrouding it in secrecy.

(d) Finally, tax accrual workpapers may also contain the accountant's—and, indirectly, the taxpayer's—opinions and judgments about the propriety of the corporation's reporting positions and about the potentials for and strength of an IRS challenge to those positions. These opinions and judgments will, of course, be inextricably mixed in with factual data and characterizations of the factual data. So also, of course, the taxpayer's return is an amalgam of facts, opinions and judgments.

The purpose of obtaining tax accrual workpapers is not primarily to allow the Service access to the accountant's and the taxpayer's "opinions" and "theories" about what is the correct tax liability. Once the relevant facts

are brought to its attention, the Service will make its own appraisal. The Service's chief interest is to discover all of the relevant facts—and these workpapers may be of critical importance in allowing it to do so.

It may, however, be the case that in a given instance the papers will help the investigating agent by highlighting the vulnerabilities of the taxpayer's positions and by suggesting alternative theories with respect to the appropriate tax treatment of a given transaction. But, absent any evidentiary privilege barring production of such documents (see pp. 28-39, *infra*), disclosure of the accountant's appraisals is consistent with the policy that the audit process and the attendant summons procedure "is to determine the truthful scope of the taxpayer's liability, rather than to engage in a sophisticated game of hide and seek." *United States* v. *Price Waterhouse & Co.*, 515 F. Supp. 996, 1000 (N.D. Ill. 1981). See also *United States* v. *McKay*, 372 F.2d 174, 176 (5th Cir. 1967).

As the Fifth Circuit noted in *United States* v. *El Paso Co.*, 682 F.2d 530, 534 (1982), the number of potential disputes over the tax treatment of items by a large corporation is "enormous." For fiscal year 1981, while corporate returns constituted 6.1% of returns examined, 60.3% of the dollar deficiencies (totalling $4.33 billion) proposed, involved corporate taxes. Commissioner of Internal Revenue and the Chief Counsel for the Internal Revenue Service. *1981 Annual Report* 12-13. The task facing the Internal Revenue Service in insuring compliance with the tax law is correspondingly enormous and should not be stultified by limiting access to relevant material in the absence of compelling factors. See *Donaldson* v. *United States*, *supra*, 400 U.S. at 535-536; *United States* v. *El Paso Co.*, *supra*, 682 F.2d at 545.

To be sure, Amerada may find disclosure of respondent's tax accrual workpapers to be disagreeable. "The divulgence of potentially incriminating evidence against [the taxpayer] is naturally unwelcome. But [the tax-

payer's] distress would be no less if the divulgence came not from [its] accountant but from some other third party with whom [it] was connected and who possessed substantially equivalent knowledge of [its] business affairs." *Couch* v. *United States*, *supra*, 409 U.S. at 329.

If Amerada had sought to obtain a substantial line of credit from a bank which, as a condition of advancing the credit, had engaged an accountant to conduct an independent audit of Amerada, neither that auditor, nor Amerada, nor its own regular auditor, could seriously contend that tax accrual workpapers generated in such an audit would be immune from compelled disclosure pursuant to an IRS summons. Like any other third-party evidence, the bank's papers and those of its outside auditor would be subject to disclosure. See *Donaldson* v. *United States*, *supra*, 400 U.S. at 535-536.

There is, we submit, no significant difference between the foregoing example and the tax accrual workpapers at issue here, because—as we shall now show—nothing in the relationship between Amerada and its independent auditor, respondent Arthur Young & Co., warrants the creation of an evidentiary privilege barring the production of such concededly relevant evidence. "* * * [T]his Court has consistently construed congressional intent to require that if the summons authority claimed is necessary for the effective performance of congressionally imposed responsibility to enforce the tax code, that authority should be upheld absent express statutory prohibition or substantial countervailing policies." *United States* v. *Euge*, *supra*, 444 U.S. at 711. No such statutory policies or countervailing policies bar the production of the papers at issue.

C. The tax accrual papers are not protected from disclosure by either a work-product privilege or an accountant-client privilege

1. In refusing to order production of the tax accrual workpapers prepared by respondent in connection with its determination of the adequacy of Amerada's reserve for

contingent tax liabilities and its certification of Amerada's financial statements, the court of appeals relied upon the attorney work-product doctrine established by this Court's decision in *Hickman* v. *Taylor*, 329 U.S. 495 (1947). In *Hickman*, the Court recognized a qualified privilege against pretrial discovery for certain materials prepared by an attorney "acting for his client in anticipation of litigation" (329 U.S. at 508). See *United States* v. *Nobles*, 422 U.S. 225, 236-240 (1975); *Upjohn Co.* v. *United States*, 449 U.S. 383, 397-399 (1981). In so holding, the Court expressed the view that a lawyer should have "a certain degree of privacy, free from unnecessary intrusion by opposing parties and their counsel" so that he may "prepare his legal theories and plan his strategy without undue and needless interference" (*Hickman* v. *Taylor*, *supra*, 329 U.S. at 510-511).

a. The policies underlying the *Hickman* rationale demonstrate that the work-product doctrine should not be extended from lawyers to accountants. Indeed, we are aware of no case, apart from the decision below, that has proposed such an extension. The fact that the law has recognized an attorney work-product privilege but not an accountant work-product privilege rests on important practical differences between the function of an accountant and that of an attorney. The attorney is the client's confidential advisor, and an advocate whose duty it is to present the client's case to the whole world in the most favorable light possible.[14] An independent certified public accountant

[14] There are, of course, certain ethical restrictions imposed upon an attorney in the conduct of his advocacy. For example, Disciplinary Rule 7-102(A) of the Model Code of Professional Responsibility (1976) forbids the knowing use of perjured testimony or false evidence, or counseling a client to engage in illegal or fraudulent conduct. But section (B) of that same rule prohibits revealing even perjury to the relevant tribunal if the attorney's knowledge of the perjury rests on privileged communications, *i.e.*, from the client. Moreover, Ethical Consideration 7-4 requires the attorney to urge any construction of law or facts favorable to his client if the construction is "*supportable* by a good faith argument for an exten-

performs a sharply different function. As the title implies, he reports not to the client but to the public. He does not serve as the client's private and confidential advisor, but rather as an instrument of public oversight. The law shields the mental processes of the attorney because the product of those processes—the rendering of thoughtful legal advice—has long been deemed to be entitled to privacy. But the product of the accountant's mental processes is in no way designed to be private advice. It is designed to constitute a public report on the adequacy of the client's financial disclosures. There is no doubt whatever that if respondent had concluded that Amerada's tax reserves were inadequate, it would have been duty-bound publicly to disclose that opinion, presumably through a qualification in its certification. There is, therefore, no good reason to cloak in privacy the facts and analytical processes that led to the very judgment that all concede must be fully disclosed to the public as a public judgment.

An attorney, however, is not supposed to be "independent" of the client. His duty is to give the client undivided loyalty. On the other hand, the independent certified public accountant—again as the title implies—is meant to be "independent." His responsibility is not only to the client whose books he is auditing but also to various governmental agencies regulating his client's industry, to his client's creditors, and to investors in his client's securities. Thus, ET Section 52 of the Code of Ethics adopted

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sion, modification, or reversal of the law" (emphasis added), *i.e.*, even if the attorney himself does not believe in the argument. Model Code of Professional Responsibility 36C, 32C (1976). See also Rule 1.6 Model Rules of Professional Conduct (Proposed Final Draft 1981), dealing with confidentiality of information. Model Rules of Professional Conduct 9 (Final Draft 1982). The ABA House of Delegates amended this proposal to protect against disclosure of information by an attorney that his client is about to commit a nonviolent crime (*e.g.*, fraud), but the ABA itself has not taken final action on the proposed rules. See N.Y. Times, Feb. 9, 1983, at A24, col. 1.

by the American Institute of Certified Public Accountants states that "[*A*] *certified public accountant should maintain his integrity and objectivity and when engaged in the practice of public accounting, be independent of those he serves.*" *AICPA-Professional Standards* 4291 (1982; emphasis in original). The independent public accounting firm is expected to maintain financial as well as mental independence from the client. Neither the firm nor its employees is permitted any direct or indirect interest in the client (ET Section 101, AICPA, *supra*, at 4411-4412) and its attitude to the client should be "a judicial impartiality that recognizes an obligation for fairness not only to management and owners (shareholders) of a business, but also to creditors and those who may otherwise rely (in part, at least) upon the auditor's report, as in the case of prospective owners or creditors" (R. Wixon, W. Kell & N. Bedford, *Accountants' Handbook* 26.10 (5th ed. 1970) [hereinafter cited as *Accountants' Handbook*], quoting AICPA Committee on Auditing Procedure (Statement on Auditing Procedure No. 33)).

The independence of an outside accounting firm, when it is engaged to render an opinion on financial statements (as respondent was in this instance), requires that it avoid not only outright misstatements or omissions but also "any type of presentation that would tend to favor the client company at the expense of those who read and rely on the financial statements examined" (*Accountants' supra*, at 26.10). See also *Gold* v. *DCL Inc.*, 399 F. Supp. 1123 (S.D.N.Y. 1973). Its responsibilities to the public require it to inform the public when the client has not presented its financial status fairly, by qualifying its opinion. *Accountants' Handbook, supra*, at 26.27. Finally, in contrast to the attorney's qualified duty to correct frauds on the court provided his knowledge does not come through privileged client communications (DR 7-102(B) Model Code of Professional Responsibility, *supra*), the independent public accountant has a continuing duty to inform the public of misstatements or errors in

the client's audited statements when the accountant has certified them. "The accountant owes a duty to the public not to assert a privilege of silence until the next audited annual statement comes around in due time." *United States* v. *Natelli*, 527 F.2d 311, 319 (2d Cir. 1975).[15]

The public accountant's multiplicity of loyalties exposes accountants to suits by regulatory agencies, creditors, and investors on the theory that the accountant ignored his duty to them in favor of his loyalty to his client. In such suits, it is common for accountants to disclose their clients' confidential communications and their own work product in order to demonstrate that they properly discharged their duties to all.[16] Indeed, it was precisely those differences between accountants and attorneys that this Court recognized in *Couch* in rejecting an analogous claim of an accountant-client privilege as to a taxpayer's records turned over to an accountant. As the Court stated (409 U.S. at 335-336):

> [T]here can be little expectation of privacy where records are handed to an accountant, knowing that mandatory disclosure of much of the information therein is required in an income tax return. What information is not disclosed is largely in the accountant's discretion, not * * * [the taxpayer's]. Indeed,

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[15] See Note, *The Duties and Obligations of the Securities Lawyer: The Beginning of a New Standard for the Legal Profession?*, 1975 Duke L. J. 121, for a detailed analysis of the distinction between the roles of lawyers and accountants and the unique responsibilities to the public imposed on securities lawyers by the courts and by the regulations of the Securities and Exchange Commission.

[16] See, *e.g.*, *Pegasus Fund, Inc.* v. *Laraneta*, 617 F.2d 1335 (9th Cir. 1980) (respondent Arthur Young & Co. produced its workpapers to show that it had no reason to know of fraud by its client); *Oleck* v. *Fischer*, 623 F.2d 791 (2d Cir. 1980) (Arthur Andersen & Co. testified regarding reserves for notes payable appearing in client's financial statement); *Herzfeld* v. *Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27 (2d Cir. 1976); *SEC* v. *Geotek*, 426 F. Supp. 715 (N.D. Cal. 1976), aff'd, 590 F.2d 785 (9th Cir. 1979).

> the accountant risks criminal prosecution if he willfully assists in the preparation of a false return. * * * His own need for self-protection would often require the right to disclose the information given him. * * * Accordingly, * * * [the taxpayer] cannot reasonably claim * * * an expectation of * * * privacy or confidentiality.

Given the independence of the certified public accountant from his client, and given the fact that his function is to make public reports rather than to give confidential advice, it is plain that the *Hickman* doctrine should not apply to the accountant's workpapers. Privacy is accorded to a lawyer in the preparation of his legal theories and strategy because they are undertaken for the sole benefit of his client and because we want clients to have access to confidential legal advice. In contrast, the accountant's opinion of the adequacy of the tax contingency reserve account is designed to be public knowledge for the benefit of a public corporation's creditors, investors, and the Securities and Exchange Commission. There is therefore no policy justification under the *Hickman* rationale for enshrouding in secrecy the facts and interpretations which lead to that publicly-available judgment by the accountant.

b. The work-product doctrine is also inapplicable to the accountant tax accrual workpapers because they were prepared in the course of a regular audit of financial statements and not in connection with litigation no matter how remotely contemplated.[17] According some degree of confidentiality to lawyers' work product prepared in connection with litigation is consistent with "the public policy underlying the orderly prosecution and defense of legal claims." *Hickman* v. *Taylor*, *supra*, 329 U.S. at

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[17] The work-product doctrine would, of course, protect workpapers that an accountant prepares when engaged by an attorney in preparation for litigation. *In re Grand Jury Subpoena*, 599 F.2d 504, 513 (2d Cir. 1979); cf. Fed. R. of Civ. P. 26(b)(3), advisory committee.

510. If such materials were open to opposing counsel on demand, the Court in *Hickman* concluded that "Inefficiency, unfairness and sharp practices would inevitably develop in the giving of legal advice and in the preparation of cases for trial" (*id.* at 511). The result would be that counsel would be able to derive advantage from the efforts of his opponent.

These policies have no bearing upon the instant case because the papers at issue were not prepared in connection with litigation. Rather, the tax accrual workpapers were prepared to comply with the regulations of the Securities and Exchange Commission. See *United States* v. *El Paso Co.*, 682 F.2d 530 (1982), petition for cert. pending, No. 82-716 (tax accrual analyses prepared by house counsel not work product because they were not prepared with even the remotest contemplation of litigation). 682 F.2d at 542-544.

Neither respondent nor Amerada claims that the tax accrual workpapers would qualify as traditional work product, and the record fails to support any inference that litigation was, in fact, contemplated when these workpapers were created. As codified in Fed. R. Civ. P. 26(b), the work-product doctrine protects against discovery "the mental impressions, conclusions, opinions, or legal theories of an attorney or other representative of a party *concerning litigation*" (emphasis added). It does not protect the mental impressions, etc. of anyone, including an attorney, if they do not concern litigation. Rather, the rule contemplates that "documents not obtained or prepared with an eye toward litigation" should be freely produced on a showing of relevance. See Fed. R. Civ. P. 26(b) advisory committee notes. Accord: *Coastal States Gas Corp.* v. *Department of Energy*, 617 F.2d 854, 864 (D.C. Cir. 1980) ("[work-product doctrine] has uniformly been held to be limited to documents prepared in contemplation of litigation"); *Goosman* v. *A. Duie Pyle, Inc.*, 320 F.2d 45, 52 (4th Cir. 1963) (reports prepared in ordinary course of business under Interstate

Commerce Commission regulations are not work product). Accordingly, the attorney work-product privilege, whether founded on *Hickman* v. *Taylor*, or on Rule 26(b)(3), does not extend to respondent's tax accrual workpapers.

2. Although the court of appeals cited *Hickman* v. *Taylor*, *supra*, 329 U.S. at 495, as the principal authority in support of its decision, it is plain that its reasoning was not primarily based on the *Hickman* rationale. Rather, the court's concern focused on fostering candid communications from client to accountant. As the court of appeals stated, "The prejudice involved in exposing to the Service appraisals of a taxpayer's weaknesses and settlement positions on audits is of such proportions that a prudent organization might not be perfectly candid with independent auditors once it knew that the information revealed would be reachable under § 7602" (Pet. App. 30a).

The court's emphasis on candid communications between client and accountant—for the supposed benefit of the investing public and the enforcement of the securities laws—indicates that the court was establishing the basis for a communications privilege. *Upjohn Co.* v. *United States*, *supra*, 449 U.S. at 389; *United States* v. *El Paso Co.*, *supra*, 682 F.2d at 541 n.13; *In re Sealed Cases*, 676 F.2d 793, 808-809 (D.C. Cir. 1982). But this Court and every court that has considered the issue (apart from the court below) has rejected the creation of an accountant-client privilege. *Couch* v. *United States*, *supra*, 409 U.S. at 335.

In *Couch*, the Court ruled that the Fifth Amendment rights of a taxpayer were not violated by the enforcement of a documentary summons directed to her accountant and requiring production of the taxpayer's own records in the possession of the accountant. It did so on the ground that in such a case "the ingredient of personal compulsion against an accused is lacking" (409 U.S. at 329). In so holding, the Court rejected the taxpayer's argument that "the confidential nature of the accountant-

client relationship and her resulting expectation of privacy in delivering the records protect[ed] her, under the Fourth and Fifth Amendments, from their production" (409 U.S. at 335). The Court flatly stated, "Although not in itself controlling, we note that no confidential accountant-client privilege exists under federal law, and no state-created privilege has been recognized in federal cases" (*ibid.*).[18]

The reasons underlying the judicial rejection of an accountant-client communication privilege derive from the distinctions between lawyers and accountants that we have discussed (pp. 29-35, *supra*) in connection with the attorney work-product doctrine. The lawyer's work product and the communications between lawyer and client are protected from compelled disclosure because the lawyer owes undivided loyalty to champion his client's interests against all others and because the relationship is meant to be confidential.[19] The accountant, however, makes public judgments and reports based on a duty to the public and to public law enforcement bodies. The

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[18] See, *e.g.*, *Wm. T. Thompson Co.* v. *General Nutrition Corp.*, 671 F.2d 100, 103-104 (3d Cir. 1982); *United States* v. *Gurtner*, 474 F.2d 297, 299 (9th Cir. 1973); *United States* v. *Wainwright*, 413 F.2d 796, 803 (10th Cir. 1969); *United States* v. *Kovel*, 296 F.2d 918, 922 (2d Cir. 1961); *Falsone* v. *United States*, 205 F.2d 734 (5th Cir.), cert. denied, 346 U.S. 864 (1953). See also *Gariepy* v. *United States*, 189 F.2d 459, 463-464 (6th Cir. 1951); *Himmelfarb* v. *United States*, 175 F.2d 924, 939 (9th Cir.), cert. denied, 338 U.S. 860 (1949); *Olender* v. *United States*, 210 F.2d 795, 806 (9th Cir. 1954).

[19] The attorney may reveal confidential communications if the client sues him about the quality of representation (*Tasby* v. *United States*, 504 F.2d 332, 336 (8th Cir. 1974)), or if the communication was made in furtherance of on-going or future criminal activity and the attorney's defense against criminal prosecution regarding the criminal activity requires disclosure of the communication (*Housler* v. *First Nat'l Bank of East Islip*, 484 F. Supp. 1321 (E.D.N.Y. 1980)). Cf. *Myerhoffer* v. *Empire Fire & Marine Insurance Co.*, 479 F.2d 1190 (2d Cir. 1974) (attorney permitted to reveal confidences when he was a defendant in a civil suit involving the securities law).

very purpose of client communications to him is to enable the accountant to exercise his discretion to disclose all relevant information to the public or public agencies. Hence, there is no justification for cloaking in secrecy a client's communications with his accountant, and the accountant's tax accrual papers should not be protected by either a work-product or a communications privilege.

3. In light of the foregoing, it is not surprising that no other court has protected tax accrual workpapers from an Internal Revenue summons on the ground of privilege or policy. In *United States* v. *El Paso Co.*, *supra*, the Fifth Circuit enforced an Internal Revenue summons for tax accrual workpapers prepared by a public corporation's in-house accountants and attorneys, and communicated to its independent accountants in connection with the establishment of a reserve for contingent tax liabilities and the certification of its financial statements. The court relied on this Court's admonition in *Couch* that there is no federal accountant-client evidentiary privilege, and rejected "[t]he logic of [the decision below that] implies that the taxpayer's revelation of tax accrual workpapers to an accountant should be considered a communication in confidence" (682 F.2d at 540-541).[20]

In *United States* v. *Price Waterhouse & Co.*, 515 F. Supp. 996 (N.D. Ill. 1981), the district court rejected Price Waterhouse's claim that its "thoughts, ideas and

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[20] El Paso resisted the summons arguing, *inter alia*, that because the tax accrual analysis was conducted by employees who were attorneys, the documents were privileged either under the attorney-client privilege or the attorney work-product doctrine. The court assumed that the attorney-client privilege might have been applicable (682 F.2d at 539). However, it enforced the summons because El Paso had discussed the tax accrual analyses with its outside auditors and thereby waived any privilege that might have applied to these records (*id.* at 540). The court held that El Paso waived any presumed attorney-client privilege because no accountant-client privilege existed. By communicating to a non-privileged party —the outside auditor—El Paso forfeited whatever privileged status might have been accorded to the communication.

opinions" (*id.* at 998 n.4) are not subject to an Internal Revenue summons. The court understood Price Waterhouse to be objecting to revealing its thoughts and opinions on issues that the Internal Revenue Service may not have pinpointed on its own in the course of the audit (*ibid.*). But the court concluded that protection of such documents is not justified because it would turn the audit into "a sophisticated game of hide and seek" (*id.* at 1000), in which the accountants would turn material over if the agent guesses right and claim privilege if the agent guesses wrong.[21]

Finally, in *United States* v. *Arthur Andersen & Co.*, 474 F. Supp. 322 (D. Mass. 1979), appeal of one party dismissed, 623 F.2d 720 (1st Cir.), cert. denied, 449 U.S. 1021, aff'd as to second party, 623 F.2d 725 (1st Cir. 1980),[22] the district court refused to create a privilege to protect Arthur Andersen's tax accrual workpapers. It relied on this Court's opinion in *Couch*, and this Court's

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[21] Compare *United States* v. *Procter & Gamble*, 356 U.S. 677, 682-683 (1958) ("Modern instruments of discovery serve a useful purpose * * *. They together with pretrial procedures make a trial less a game of blindman's buff and more a fair contest with the basic issues and facts disclosed to the fullest practicable extent * * *. Only strong public policies weigh against disclosure."); see also *Rozier* v. *Ford Motor Co.*, 573 F.2d 1332, 1345-1346 (5th Cir. 1978).

[22] Neither the corporate taxpayer nor the independent auditor in *Arthur Andersen & Co.* obtained a stay of the district court decision. Hence, the auditor produced the tax accrual papers, and its appeal with respect to that issue was dismissed as moot (623 F.2d 720 (1st Cir. 1980)). The taxpayer's appeal challenged, *inter alia*, the relevance of the Service's questioning the auditor with respect to the workpapers. Before addressing the taxpayer's claim that the requested testimony of the auditor was not relevant, the court of appeals first expressed agreement with this Court's admonition in *Couch* v. *United States*, *supra*, 409 U.S. at 335, that there is no recognized accountant-client privilege. See pp. 5-6, *supra*. The court of appeals held that the taxpayer's appeal as to the relevancy of the auditor's testimony was premature until such questioning was in fact resisted (623 F.2d at 729-730).

broad construction of the Internal Revenue Service's statutory summons power (474 F. Supp. at 327).[23]

D. The rationale for a communications privilege is not applicable to this case

Even if some communications between client and accountant could be deemed privileged, the rationale for such a privilege does not exist in this case. The principal contemporary justification for the attorney-client privilege is its presumed value in encouraging clients to make full disclosure to their attorneys, *Upjohn Co.* v. *United States*, *supra*, 449 U.S. at 389; 8 J. Wigmore, *supra*, §§ 2291 and 2306, at 590. Clients, of course, have no legal duty fully to inform their lawyers; without the privilege, therefore, disclosure might be deterred and it might be difficult to obtain fully informed legal advice. "[S]ince the privilege has the effect of withholding relevant information from the factfinder, it applies only where necessary to achieve its purpose. Accordingly, it protects only those disclosures—necessary to obtain legal advice—which might not have been made absent the privilege." *Fisher* v. *United States*, 425 U.S. 391, 403 (1976).

There is no substantial basis for the court of appeals' assumption that the production of tax accrual workpapers would cause corporations to withhold information

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[23] Cf. *United States* v. *Coopers & Lybrand*, 413 F. Supp. 942 (D. Col. 1975), aff'd, 550 F.2d 615 (10th Cir. 1977). There, the court refused to enforce a summons for tax accrual workpapers on the ground that they were not relevant to the Internal Revenue audit, relying, in part, on the fact that they were not created in the course of preparing the taxpayer's tax return. This narrow definition of relevance has not been followed in subsequent decisions of other courts, including the Tenth Circuit itself. *United States* v. *El Paso Co.*, *supra*; *United States* v. *Noall*, 587 F.2d 123, 125-126 (2d Cir. 1978), cert. denied, 441 U.S. 923 (1979); and *United States* v. *Southwestern Bank & Trust Co.*, 693 F.2d 994 (10th Cir. 1982); *United States* v. *City National Bank & Trust Co.*, 642 F.2d 388 (10th Cir. 1981).

from their outside auditors.[24] As a publicly-held corporation, Amerada was required to file accurate and complete financial statements, certified by its independent auditors, with the SEC, if it wished to continue to have its stock publicly traded. See 15 U.S.C. 78*l* and m; 17 C.F.R. 210.1-01, 210.1-02(a), (d), and (f), 210.2-01. Thus, Amerada had an independent legal duty to make full disclosures to respondent, without reference to or encouragement by any privilege. As the dissenting judge pointed out, there is accordingly no justification for the majority's premise "that some corporations are so anxious to minimize their tax payments that they are willing to deceive their accountants concerning the existence of debatable tax items and thereby violate their obligations under the securities law" (Pet. App. 36a; footnotes omitted). See also *United States* v. *El Paso Co.*, *supra*, 682 F.2d at 544.

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[24] There is certainly nothing in the record to support such an inference. The only factual submission put forward by respondent on this point was the unsupported self-serving statement of its counsel that (J.A. 32):

> Clients would be reluctant to provide necessary information * * * [if the tax accrual workpapers were disclosed]. The devastating impact of this to the auditing profession and to the primary objectives of that audit, the integrity of the financial statements, is obvious.

Surely an evidentiary privilege that undercuts the powerful governmental interest in collecting taxes should rest on something more substantial than the self-serving speculation by an interested party. In *Branzburg* v. *Hayes*, *supra*, this Court rejected similar arguments advanced in support of creating a newsman's privilege. The reporters in that case had argued that their confidential sources would dry up if the sources believed that the reporter might be required to testify before a grand jury regarding the identity of the source or the information obtained from the source. The Court found the argument unpersuasive because the asserted result was highly speculative (408 U.S. at 693-694) and because, even if the ill-effect were assumed to occur in the future, it would not outweigh the present public interest in obtaining the information from the reporters (*id.* at 695). Cf. *Hawkins* v. *United States*, 358 U.S. 74, 81-82 (Stewart, J., concurring).

The cost of engaging in the financial deceit that the court below predicted would occur in the absence of a privilege is very high. If an accountant refuses to certify a public corporation's financial statements, the corporation may be excluded from the public capital markets and may be exposed to private causes of action. Respondent was, therefore, hardly at the mercy of its client in these circumstances. When confronted with an independent accountant's demand for additional information, the client has only three choices: (1) to provide the accountant the information requested; (2) to reconcile itself to receiving a qualified opinion, or (3) to discharge the accountant. See *In re John Doe Corp.*, 675 F.2d 482, 484-489 (2d Cir. 1982).

From the client's point of view, the latter two alternatives are highly undesirable. A qualified opinion would damage the client by revealing the nature, if not the facts, of the problem. Discharging the accountant would likewise harm the client because, under the securities regulations, a listed company must inform the Securities and Exchange Commission, as well as its shareholders, whenever its independent accountant resigns or is discharged (see 17 C.F.R. 249.308 and 240.14a-3(b)(4); 4 Fed. Sec. L. Rep. (CCH) ¶ 31,001, Form 8-K, Item 4, at 21,995 (May 4, 1983)); explain whether there had been any disagreements over an accounting treatment or principle in connection with the audits of the two most recent fiscal years; and request the former accountant to inform the Commission whether the accountant agrees with the company's response to Item 4. In addition, if a change of accountants has been reported in a Form 8-K during the 24 months immediately preceding the registration of new securities, the registrant must disclose the nature of the disagreement with the accountant and explain the effect on the financial statement of not having followed the former accountant's opinion (17 C.F.R. 229.304).

It is therefore the accountant's public duty to withhold certification of a false, incomplete or misleading state-

ment, and it is the sanctions of the securities laws—not the existence of any privilege—that provide the corporation with the necessary incentive to be candid with its independent auditor (see Pet. App. 37a-38a). The rationale for a communications privilege is accordingly inapplicable to this case.[25]

E. The court of appeals erred in assuming a conflict between the IRS summons authority and the securities regulation statutes

1. The court of appeals further erred in assuming a conflict between the federal statutes regulating securities and those enforcing revenue collection. Section 7602 of the 1954 Code unequivocally authorizes agents of the Internal Revenue Service to summon and inspect records that may be relevant to their investigation. On the other hand, the securities regulations relate to nothing more than the duty of listed corporations to file annual audited

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[25] *Upjohn Co.* v. *United States, supra*, upon which the court of appeals relied (Pet. App. 30a n.9), is not to the contrary. There, the Court held that the attorney-client privilege protected communications from a corporation's employees to its general counsel, who was conducting an investigation of questionable payments made by one of the corporation's foreign subsidiaries. In so holding, the Court rejected the government's argument that the privilege was inapplicable because the risk of civil or criminal liability would ensure that corporations would seek legal advice even in the absence of the privilege. The Court observed that absent the privilege, the depth and quality of any investigations to insure compliance would suffer. The Court added that the argument proved too much because even a corporation seeking to comply with the law has a strong incentive to disclose information to its lawyer (449 U.S. at 393 n.2).

But these considerations have no application here where the securities laws independently require certified financial statements made by accountants who have a separate and distinct obligation to the public. Hence, the law and not any privilege ensures candid communications between the public corporation and its outside auditor. In sharp contrast, consultation with an attorney is a voluntary act that the attorney-client privilege is designed to facilitate. See *United States* v. *El Paso Co., supra*, 682 F.2d at 544-545 n.16.

statements, and the duty of auditors to examine the statements under generally accepted principles of public accounting. The statutes and regulations do not even hint at any duty of accountants to keep their clients' communications confidential. It would be particularly incongruous to order accountants to do so when their basic function is to insure that the public is informed accurately.

As the Court made clear in *St. Regis Paper Co.* v. *United States*, 368 U.S. 208 (1961), a clear statement of congressional purpose is required to create a special rule preventing the disclosure of relevant information to a duly authorized government agency. In *St. Regis Paper Co.*, the Court construed Section 9(a) of the Census Act, 13 U.S.C. (1958 ed.) 9(a), which prohibits the Census Bureau from disclosing census information except in the form of statistical reports. St. Regis asserted that this prohibition was, in effect, a pledge of confidentiality and protected the company from having to disclose the same information to the Federal Trade Commission. This Court disagreed, holding that the statute merely forbade dissemination of the information by the Census Bureau; the statute did not curtail the normal investigatory powers of other government agencies: "Ours is the duty to avoid a construction that would suppress otherwise competent evidence unless the statute, strictly construed, requires such a result. * * * [W]hen Congress has intended like reports not to be subject to compulsory process it has said so. See 45 U.S.C. § 41, 49 U.S.C. § 320(f) (footnotes omitted)." 368 U.S. at 218. The present case follows a fortiori from *St. Regis Paper Co.*, since the securities laws and regulations do not contain any requirements of confidentiality for accountants.

2. Even if there were a potential conflict between the policies underlying the securities laws and the tax enforcement laws, the resolution of such a conflict of policy properly lies in Congress and not in the courts. The securities laws do not, on their face, create any exception to

the Internal Revenue Service's summons authority; a literal reading of the revenue provision plainly directs that relevant documents be produced. There is no justification for the assumption of the court below that the securities laws somehow limit or cut back on the scope of the Internal Revenue Service's summons authority. "One canon of construction is that repeals by implication are disfavored." *Regional Rail Reorganization Act Cases*, 419 U.S. 102, 133 (1974). Since the IRS summons statutes and the securities laws are " 'capable of co-existence, it is the duty of the courts, absent a clearly expressed congressional intention to the contrary, to regard each as effective.' " *Id.* at 133-134, quoting *Morton* v. *Mancari*, 417 U.S. 535, 551 (1974). "With respect to enforcement of the tax laws, Congress itself has decided the policy issue, and it is not for the courts to challenge that determination." *United States* v. *Noall*, *supra*, 587 F.2d at 126. See also *FTC* v. *TRW, Inc.*, 628 F.2d 207, 210 (9th Cir. 1980). As the Fifth Circuit put it in *El Paso Co.* in reaching the opposite conclusion from that of the court below (682 F.2d at 545): "In the absence of a more profound clash between congressional policies, we cannot cut back on the summons power that Congress has given to the Service. We do not feel free to reweave the fabric of national legislation in accord with our notions of how various statutory schemes mesh. Such policy choices belong to the Congress."

CONCLUSION

The judgment of the court of appeals should be reversed, and the summons ordering production of the tax accrual workpapers should be enforced.

Respectfully submitted.

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No. 82-687

IN THE

Supreme Court of the United States

October Term, 1982

UNITED STATES OF AMERICA,

Petitioner,

vs.

ARTHUR YOUNG & COMPANY

and

AMERADA HESS CORPORATION,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR ARTHUR YOUNG & COMPANY

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September 9, 1983

QUESTION PRESENTED

May the Internal Revenue Service summon tax accrual workpapers which are prepared by an independent auditor in compliance with his responsibilities under the federal securities laws and which disclose the taxpayer's and its auditor's private opinions, theories, legal strategies and possible compromise positions with the Service, where:

1. the Service has access to all the transactional data and other facts needed to determine tax liability from the records of the taxpayer and the audit workpapers of its auditor;

2. there are no allegations of fraud; and

3. the Service has failed to make a showing of substantial need for the tax accrual workpapers or their specific relevance to the correctness of the taxpayer's return, but has relied instead on a claim of convenience?

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II.

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In The

Supreme Court of the United States

October Term, 1982

UNITED STATES OF AMERICA,

Petitioner,

v.

ARTHUR YOUNG & COMPANY
and
AMERADA HESS CORPORATION,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

ADDITIONAL STATUTE INVOLVED

Fed. R. Evid. 501, prescribed by this Court in 1974 pursuant to 18 U.S.C. §§ 3402, 3771 and 3772 and 28 U.S.C. §§ 2072 and 2075, and approved by Congress, Pub. L No. 93-595, 88 Stat. 1926 (1975), provides in pertinent part that:

> the privilege of a witness, person, government, State, or political subdivision thereof shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience....

STATEMENT OF THE CASE

A. *The Sufficiency of the Data Provided to the Service*

Petitioner's claim that the independent auditor's tax accrual workpapers* contain facts needed to enable the Service to perform its role as tax collector finds no support in the

*Also known as tax cushion or tax contingency reserve files, tax pool analysis and tax liability contingency analysis.

record. On the contrary, the record and the findings of the Court below (which petitioner does not challenge) show:

1. The Service has had access to virtually every piece of paper in Amerada's files relating to its 1972, 1973 and 1974 tax returns. In addition to making its financial and transactional records and those of its banks available to the Service (JA* 64), Amerada responded to more than 398 civil document requests by producing approximately 45,000 pages of documents relating to its returns. (JA 86, 65) The Service also conducted 36 sworn interviews of employees, officers and directors of Amerada. (JA 92) Amerada estimates that between 1975 and 1979 at least 11,500 man hours of personnel time were expended in responding to requests by the Service for information. (JA 64)

2. The "corporation's own books and the audit workpapers [of the independent auditor] furnish the IRS with all the raw data it needs to calculate the taxpayer's tax liability" and "should be sufficient for its purpose of determining the accuracy of Amerada's returns." (PA** 31a, 32a)

3. "There is no factual data relating to Amerada transactions in the tax accrual papers which is not otherwise available in the taxpayer's records or in publicly available documents." (JA 31-32; *see also* JA 38)

B. *The Nature of an Independent Auditor's Tax Accrual Workpapers*

In an attempt to diminish the unique and sensitive nature of an independent auditor's tax accrual workpapers, petitioner fails to describe accurately their contents and their preparation. (*See* Pet. Br. at 3-4, 24-27) Tax accrual workpapers are not prepared in connection with the tax return. (JA 32) They are prepared exclusively for financial disclosure purposes mandated by the federal securities laws and the regulations of the Securities and Exchange Commission ("SEC") thereunder. (JA 32)

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* "JA" refers to the Joint Appendix.

** "PA" refers to the appendix to the Petition for a Writ of Certiorari.

Those laws and regulations require respondent Amerada, a publicly-held corporation, to file with the SEC audited financial statements containing an opinion of an independent public accountant as to whether the statements were prepared in accordance with generally accepted accounting principles.* The independent public accountant must form an opinion regarding the fairness of presentation of the corporation's financial condition, including the adequacy of the stated reserve for potential tax liability.** (JA 27)***

During the process of verifying the tax reserve, the independent auditor reviews the books of account and evaluates the projections, hypotheses and speculations of Amerada's financial officers and legal counsel regarding potential

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*Financial statements must be audited whenever a publicly-owned corporation registers a new stock issue, Securities Act of 1933, Schedule A (25-27), 15 U.S.C. § 77aa (1970); registers securities for listing on an exchange, Securities Exchange Act of 1934, *as amended*, §§ 12 (b)(1)(J)-(L), 12(g)(1), 15 U.S.C. §§ 78*l*(b)(1)(J)-(L), 78*l*(g)(1) (1970); solicits proxies in order to issue securities, modify a class of securities or attempt a merger, Schedule 14A, Item 15, 17 C.F.R. § 240.14a-101 (1976); files annual 10-K reports with the SEC, SEC Form 10-K Instructions as to Financial Statements, 4 Fed. Sec. L. Rep. (CCH) § 31,106; or issues an annual report to shareholders in connection with solicitation of proxies, 17 C.F.R. § 240.14a(3)(b)(3)-(4) (1976).

**The tax reserve is a liability account on Amerada's books which represents an estimate of possible future income tax assessments arising as a result of either (a) the Service's disallowance of deductions or credits previously taken in computing the corporation's tax liability, or (b) certain "timing difference[s]" in the financial as opposed to the tax accounting treatment of certain transactions. (JA 28-33) "The tax contingency figure" on the financial statement "is a composite of possible tax consequences, each discounted by the possibility that it will occur." Caplin, *Government Access to Independent Accountants' Tax Accrual Workpapers*, 1 Va. Tax Rev. 57, 59 (1981).

****See* Financial Accounting Standards Board, *Statement of Financial Accounting Standards* No. 5, 3 Prof. Standards (CCH) AC § 328 (Mar. 1975); American Institute of Certified Public Accountants, *Statement on Auditing Standards* No. 2, 1 [AICPA] Prof. Standards (CCH) AU § 509 (Oct. 1974); No. 17, 1 [AICPA] Prof. Standards (CCH) AU § 328 (Jan. 1977).

tax liability—often on an hypothetical, worst-case basis. (JA 30-32); *see generally* American Institute of Certified Public Accountants, *Statement on Auditing Standards* No. 1, 1 [AICPA] Prof. Standards (CCH) AU § 339.02 (1982). Among the subjects considered are possible issues which might arise as a result of the tax treatment of various corporate transactions; possible objections which the Service might raise in examining Amerada's returns; and possible responses to such challenges, including negotiation strategy, decisions to litigate or compromise, and estimates of the likelihood and outcome of administrative settlements or judicial proceedings which "are based on considerations wholly apart from the inherent legality of what the taxpayer has done, *e.g.*, the cost of litigation and the possibility that confidential business information may be disclosed to competitors." (PA 30a; *see* JA 28-33)

The tax accrual workpapers set forth the taxpayer's and the independent auditor's "speculation as to positions that might be taken by the IRS and the taxpayer, theoretical analysis, and opinions bearing on the fairness and reasonableness of the parties' positions (*as distinguished from factual transactional data*). . . ." (PA 24a) (emphasis added) They record the auditor's and taxpayer's thoughts, opinions and judgments revealed in confidence during the process of verifying the tax reserve. They contain "an item-by-item evaluation of the taxpayer's potential exposure to additional tax liability" if challenged by the Service. Caplin, *Government Access to Independent Accountants' Tax Accrual Workpapers, supra*, 1 Va. Tax. Rev. at 61. If disclosed to the Service, the tax accrual workpapers will provide a definitive "road map" pinpointing "possible vulnerable areas" in the return and announcing "how the corporation will handle the Service and vice versa, if these areas are questioned on audit." (PA 30a)

As the lower Court held, this "case does not involve allegations of fraud," and accordingly "the Service does not need to know taxpayer's thoughts" as recorded in the tax accrual workpapers. (PA 32a, 31a)

C. *The Qualified Privilege Created by the Decision Below*

When the Service summons an independent auditor's tax accrual workpapers, "it creates a clash between two important congressional policies:" protection of the fisc and protection of the investing public from inaccurate financial reporting. (PA 29a, 30a) In resolving the conflict between these competing policies, the Court below decided to tip the balance in favor of safeguarding the integrity of the independent auditing process. (PA 31a)

The Court fashioned a qualified work-product privilege for an independent auditor's tax accrual workpapers which can be invoked only when, as here: (1) the corporate taxpayer's transactional records and books of account (on which, in part, the tax accrual workpapers are based) and its certified public accountant's audit workpapers have been made available to the Service; (2) the corporation's own books and its auditor's audit workpapers furnish the Service "with all the raw data it needs to calculate the taxpayer's tax liability;" (3) there are no allegations of fraud; and (4) there is no showing by the Service of substantial need for the tax accrual workpapers (as in the case of the destruction of corporate records). (PA 31a-32a)

The Court below did not promulgate, or base its decision on the existence of, an accountant-client testimonial privilege in derogation of this Court's ruling in *Couch* v. *United States*, 409 U.S. 322, 335 (1973). Nor did it announce a general or unlimited accountant's work-product doctrine. The qualified privilege created by the lower Court does not protect communications between an accountant and his client; rather, it shields the specific work product of the independent auditor generated during the process of verifying the tax reserve and only incidentally the testimony of the auditor or taxpayer relating to that process. Since the decision in *Couch* dealt with the question of an accountant-client privilege, which is not at issue in this case, *Couch* is in no way contrary to the decision of the lower Court.

That Court noted that the independent auditor's qualified work-product privilege which it announced is analogous, but

not identical, to the work-product privilege for an attorney's trial preparation materials created by the Court of Appeals for the Third Circuit in *Hickman* v. *Taylor*, 153 F.2d 212 (3rd Cir. 1945), approved by this Court, 329 U.S. 495 (1947), codified in Fed. R. Civ. P. 26(b)(3), and expanded in *Upjohn Co.* v. *United States*, 449 *U.S.* 383, 398-99 (1981). *See also FTC* v. *Grolier, Inc.*, _____ *U.S.* _____, 103 S. Ct. 2209 (1983); *United States* v. *Nobles*, 422 U.S. 225, 236-40 (1975); *NLRB* v. *Sears, Roebuck & Co.*, 421 U.S. 132 (1975).

The Court below emphasized the unfairness to the taxpayer which would result from disclosure to the Service of the taxpayer's settlement positions and its negotiation and legal strategies which are contained in the tax accrual workpapers. (PA 29a-30a) It found that the Service did not need the tax accrual workpapers to complete its tax investigation of Amerada but had summoned them only to marshall "the best arguments for asserting a deficiency." (PA 25a, 31a)

The Court below did not accept the convenience of the Service as a justification for "invading the integrity of the auditing process" or reducing the protection complete financial disclosure provides to the investing public. (PA 31a) It held that the Service is not entitled "to summon a road map of the thoughts and theories of a taxpayer and its independent auditor" merely because it may save the Service time during its audit of Amerada's returns. (PA 31a)

THE FUNDAMENTAL UNFAIRNESS OF PETITIONER'S POSITION

It is common knowledge that the relationship between taxpayers and the Service—whether or not it results in litigation—is adversarial: the taxpayer seeks to minimize while the Service desires to maximize tax liability.

Despite the voluminous documents produced to, and the numerous interviews conducted by, the Service (*see* discussion *supra* at p. 2), petitioner professes a need for access to still more facts which it speculates are contained in the independent accountant's tax accrual work papers. Yet even

now, eight years after the inception of the civil audit (JA 63), petitioner cannot tell the Court what facts the Service needs to complete its investigation of Amerada or explain why this information could not be obtained directly from Amerada's records or financial personnel or from third parties, including the independent auditor's audit (not tax accrual) workpapers—all of which have been made available to the Service. (PA 32a) Petitioner posits certain inquiries the Service might have of a multinational corporation with respect to the "income, expenses, and level of bona fide business activity of an off-shore subsidiary." (Pet. Br. at 24) However, there is nothing in the record to suggest that these inquiries were made of Amerada or that they could not be answered satisfactorily from sources other than the independent auditor's tax accrual workpapers. In any event, the information petitioner claims the Service may need to conduct "a multinational tax audit" (Pet. Br. at 24) is required to be reported to the Service on separate schedules. *See, e.g.*, Form 5471 (Information Return with Respect to a Foreign Corporation) (January 1983) (replacing Forms 957, 958, 959, 2952 and 3646); *see also* I.R.C. § 6038A.

It is obvious, as petitioner ultimately concedes, albeit obliquely, that the Service desires access to the judgmental portions of the tax accrual workpapers for convenience, that is, to assist it in the inherently adversarial process of locating targets for investigation and developing arguments for deficiencies. For example, petitioner states that "[t]he purpose of obtaining tax accrual work papers is not *primarily* to allow the Service access to the accountant's and the taxpayer's 'opinions' and 'theories' about what is the correct tax liability" and that "[t]he Service's *chief* interest is to discover all of the relevant facts—and these workpapers may be of critical importance in allowing it to do so." (Pet. Br. at 26, 27) (emphasis added) (*see also* Pet. Br. at 10, 14, 25)

The Service admits that it seeks access to the tax accrual workpapers because they provide a "roadmap through the raw data" and "embody the taxpaper's and the accountant's judgments about which facts are *relevant* to the taxpayer's lawful tax liability." (Pet. Br. at 26) Yet, when the situation

is reversed, and a taxpayer seeks information from the Service under the Freedom of Information Act regarding its private thoughts, opinions, analyses and negotiating, litigation and settlement positions concerning the taxpaper, the Service tries to "enshroud [them] in secrecy" (Pet. Br. at 33) and generally prevails.

In those cases, the Service seeks a very expansive definition of material exempt as "tax return information" under 26 U.S.C. § 6103(e)(7). *See, e.g., White* v. *IRS*, 707 F.2d 897 (6th Cir. 1983). The Service also receives the benefit of a "highly deferential" standard of review of its discretion, and is upheld "so long as [its] determination is rational and has support in the record." *Zale Corp.* v. *IRS*, 481 F. Supp 486, 489 (D.D.C. 1979). Under this criterion, the Service may withhold virtually anything which it claims will "seriously impair tax administration" (26 U.S.C § 6103 (e)(6)) or "impair the IRS' ability to present its best case both during the administrative process as well as during litigation. . . ." *Anheuser-Busch, Inc.* v. *IRS*, 493 F. Supp. 549, 551 (D.D.C. 1980); *see also P.T. & L. Construction Co.* v. *Commissioner*, 63 T.C. 404 (1974) (limiting taxpayer's discovery of the Service in the Tax Court); *Esson* v. *Commissioner*, [1975] T.C.M. (P-H) ¶ 75,121.

Thus, petitioner espouses one rule for the taxpayer and the Service espouses another for itself.

In an adversarial process such as this, it is "fundamentally unfair" for one side to have access to the other side's private musings, ruminations, speculations, plans and strategies for conduct of the combat and for the other side to be completely foreclosed from access to the same type of information from its adversary. This Court has recently reaffirmed that despite the general rule that a litigant is entitled to "every man's evidence," specific exceptions are mandated on grounds, among others, of "fundamental fairness." *United States* v. *Sells Engineering, Inc.*, ____ U.S. ____, 51 U.S.L.W. 5059, 5063 (June 30, 1983). This principle has also recently been applied against the Service in the context of a civil audit.

United States v. *Baggot*, ____ U.S. ____, 51 U.S.L.W. 5075 (June 30, 1983).

In *United States* v. *Sells Engineering, Inc.*, *supra*, this Court held that automatic disclosure to government attorneys of grand jury materials for civil use posed "a significant threat to the integrity of the grand jury itself," made "more concrete the threat to the willingness of witnesses to come forward and to testify fully and candidly" and subverted "the limitations applied outside the grand jury context on the Government's powers of discovery and investigation." (51 U.S.L.W. at 5063) It warned that:

> If government litigators or investigators in civil matters enjoyed unlimited access to grand jury materials, there would be little reason for them to resort to their usual, more limited avenues of investigation. To allow these agencies to circumvent their usual methods of discovery would not only subvert the limitations and procedural requirements built into those methods, but would grant to the Government a virtual *ex parte* form of discovery from which its civil litigation opponents are excluded unless they make a strong showing of particularized need.

(*Id.*). In *United States* v. *Baggot*, *supra*, this Court reiterated that warning, holding that since a civil audit was not "preliminary to litigation," the Service could not gain access to confidential grand jury materials. (51 U.S.L.W. at 5076)

These determinations are particularly apposite to this case. If the Service is granted routine access to tax accrual workpapers, it will represent a significant expansion of the Service's "usual methods" of conducting audits. *United States* v. *Sells Engineering, Inc.*, *supra*, 51 U.S.L.W. at 5063. "After all, for a great many years the Service effectively employed its summons powers in routine audits. . . . of large corporate taxpayers without the necessity of attempting to acquire their 'tax pool' analyses." *United States* v. *El Paso Co.*, 682 F.2d 530, 547 (5th Cir. 1982) (Garwood, J., dissenting), *petition for cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716).

Access by the Service to the tax accrual workpapers places the taxpayer in a position of unequal bargaining power with the Service and seriously undermines the taxpayer's ability to strike reasonable settlements with the Service on good faith estimates. (JA 31-32) For an examining revenue agent, access to the independent auditor's tax accrual workpapers provides an attractively easy basis for challenging the taxpayer on the issues flagged in those documents. Moreover, by asserting such issues in a statutory notice, the Service enjoys the benefit of presumptive correctness and burdens the taxpayer with the risks and expense of litigation.

The Court below recognized correctly that:

> In reality, at the end of an audit, the IRS and the taxpayers frequently compromise out their differences, each giving in a little. Such negotiations strike an appropriate balance between collecting revenue and conserving judicial resources, but requiring the taxpayer alone to disclose settlement positions would improperly weight the balance.

(PA 29a, 30a) It also realized that divulging the information contained in the tax accrual workpapers "necessarily puts the taxpayer-corporation at a substantial disadvantage when it is audited." (*Id.*) Accordingly, the Court concluded that:

> The prejudice involved in exposing to the Service appraisals of a taxpayer's weaknesses and settlement positions on audit is of such proportions that a prudent organization might not be perfectly candid with independent auditors once it knew that the information revealed would be reachable under § 7602.

(PA 30a)

Moreover, if the Service can breach the confidentiality of the tax reserve verification process and use the tax accrual workpapers as its own audit plan, the accounting profession will be perceived as, and will effectively become, an auxiliary enforcement arm of the Service. This result was not intended by Congress. *See* Caplin, *Should the Service Be Permitted to Reach Accountants' Tax Accrual Workpapers?*, 51 J. Tax'n 194, 199-200 (1979); *see also United States* v. *Humble Oil &*

Refining Co., 518 F.2d 747, 748-49 (5th Cir. 1975) (compelling private citizens to do the Service's research exceeds the scope of § 7602 summons); *cf. SEC* v. *Arthur Young & Co.*, 590 F.2d 785, 788 (9th Cir. 1979) (refusal to conscript accountants in enforcing existing securities laws according to SEC views); *SEC* v. *Touche Ross & Co.*, 438 F. Supp. 259, 262 (S.D.N.Y. 1977) (declining to enforce the request by the SEC to support its "auditing efforts with those of an independent accountant.")

SUMMARY OF ARGUMENT

1. The Service's broad summons power under 26 U.S.C. § 7602 is subject to limitation, particularly when enforcement would undermine the goals of another federal statute. Accordingly, the Service's claim of administrative convenience must be evaluated in light of the adverse impact that disclosure of the tax accrual workpapers will or may have on the accuracy and completeness of financial reporting required by the federal securities laws and regulations on which the investing public depends.

2. Unrestricted access by the Service to tax accrual workpapers will undermine effective enforcement of the federal securities laws. The present and a former Commissioner of Internal Revenue have recognized that mandatory disclosure of an independent auditor's tax accrual workpapers will have a chilling effect on the quality of financial disclosure under the federal securities laws. This is not to assume that publicly-held corporations will deliberately shirk their financial reporting responsibilities. Rather, the chilling effect will be manifested in a more conservative approach to identifying questionable tax positions for inclusion in the tax reserve. The end result is that certified public accountants will have less information to work with, and the reports they issue for the investing public's benefit will be less accurate and complete.

3. Because it found that the Service did not need the tax accrual workpapers to complete its tax audit of Amerada, the Court below, following established authorities for resolving conflicts between federal statutes, weighed the beneficial

effects of disclosure to the investing public of the "data generated as a result of the SEC laws" more heavily than the Service's convenience. (PA 28a, 29a)

4. The lower Court's decision creating a qualified privilege for an independent auditor's tax accrual workpapers is fully supported by Rule 501 of the Federal Rules of Evidence and the analogy to the attorney's work-product privilege.

5. The decision of the lower Court should be affirmed because it resolved the conflict between competing congressional policies with minimal disruption to the exercise of the Service's summons authority while protecting the investing public and the integrity of the independent auditing process and insuring fair and reasonable treatment of the corporate taxpayer.

6. The Court below recognized that the "Service's emerging practice of requesting tax accrual workpapers" was, in effect, an attempt to force corporate taxpayers to "flag their questionable positions" as suggested by former Commissioner Kurtz. (PA 25a, 31a-32a) Shortly after the judgment below was entered, Congress adopted some of former Commissioner Kurtz's suggestions in section 323(a) of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Pub. L. No. 97-248, 96 Stat. 324 (to be codified at 26 U.S.C. § 6661). Section 6661 specifies what the taxpayer should disclose to the Service—the relevant facts relating to positions for which there may not be substantial authority. It does not require disclosure of the thoughts, opinions and judgments of the independent auditor and taxpayer which are contained in the tax accrual workpapers, and which are shielded from discovery by the Service. By seeking tax accrual workpapers, the Service is attempting to exceed Congress's recent limitation on the scope of section 7602 summons authority.

7. There are also alternative grounds for affirming the decision below: a) the tax accrual workpapers are not relevant to the Service's civil audit of Amerada; and b) the tax accrual workpapers do not contain purely factual data encompassed by 26 U.S.C. § 7602. The Court below rejected these arguments and held that any documents that "might throw

light upon" the accuracy of a taxpayer's return are relevant to an audit by the Service. (PA 27a) In other cases courts have held that a stricter standard of relevance applies when the Service seeks access to materials containing theories and opinions as opposed to transactional data, particularly when the information is sought from a third party rather than the taxpayer. This standard has been variously interpreted as requiring a showing of "sufficient relevance" or a "realistic expectation of relevance," as opposed to a claim of administrative convenience. In addition, section 7602 should be limited to purely factual data.

8. The more stringent standard of relevance has been adopted by the Service's own revised guidelines for requesting access to tax accrual workpapers. However, the Service has failed in this case to satisfy its own standard.

ARGUMENT

I.

THE COURT BELOW DID NOT ERR IN CREATING A QUALIFIED PRIVILEGE FOR THE TAX ACCRUAL WORKPAPERS OF AN INDEPENDENT AUDITOR SINCE ACCESS BY THE SERVICE WILL INHIBIT THE QUALITY AND DEPTH OF FINANCIAL REPORTING TO THE INVESTING PUBLIC REQUIRED BY THE SECURITIES LAWS

The Service has been given broad authority under section 7602 to summon the production of "books, papers, records, or other data which may be relevant or material" to a determination of a taxpayer's income tax liability. This power provides an important check on taxpayer compliance with the nation's self-assessment tax system. Nevertheless, like all broad grants of authority, the power of the tax collector is subject to abuse and should be kept within proper bounds. *See United States* v. *Bisceglia*, 420 U.S. 141, 151 (1975).

To limit the potential for abuse, Congress did not make the Service's summonses self-executing, but interposed the supervisory authority of the federal courts. *See* 26 U.S.C.

§ 7604(b); *Reisman* v. *Caplin*, 375 U.S. 440 (1964). This Court has determined that a summons will not be enforced unless the Service makes a preliminary showing:

> that the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, that the information sought is not already within the Commissioner's possession, and that the administrative steps required by the Code have been followed.

United States v. *Powell*, 379 U.S. 48, 57-58 (1964).

In each case, as this Court has held, the court must be satisfied that the summons "is necessary for the effective enforcement of the revenue laws *and is not undercut by contrary legislative purposes.*" *United States* v. *Euge*, 444 U.S. 707, 715-16 & n.9 (1980) (emphasis added).

A. *The Countervailing Legislative Policies*

The Court below recognized that there are substantial countervailing policies enunciated by Congress which favor the protection of "the work that independent auditors, retained by publicly-owned companies to comply with the federal securities laws, put into preparation of tax accrual workpapers." (PA 28a) It emphasized that:

> When the IRS chooses to regularly summon tax accrual workpapers, it creates a clash between two important congressional policies. No matter how we decide this issue, one policy has to bend a bit. Giving the complete latitude to the summons power that the IRS seeks here compromises the procedure designed by Congress to protect the investing public from inaccurate financial information. Protecting the accuracy of the securities laws dilutes the power of the Service to summon a roadmap of the thoughts and theories of a taxpayer and its independent auditor.

(PA 30a-31a)

The clash between administrative convenience in the conduct of tax investigations and the protection of the investing public from inaccurate and incomplete financial reporting was resolved in favor of "the independent auditing process."

(PA 30a, 31a) The Court reasoned that the Service had access to "all the raw data that it needs to calculate the taxpayer's tax liability" whereas the "investing public . . . relies most exclusively on the data generated as a result of the SEC laws." (PA 31a)

Petitioner maintains that the Court below "erred in assuming a conflict between the federal statutes regulating securities and those enforcing revenue collection." (Pet. Br. at 12, 42) In particular, petitioner questions the Court's assumption "that production of tax accrual workpapers would cause corporations to withhold information from their outside auditors." (Pet. Br. at 39-40) This assertion defies common sense, the record below (JA 32) and the compelling evidence of a chilling effect from mandatory disclosure of tax accrual workpapers which has appeared in the legal and financial press.

No better authority for rebutting petitioner's position and emphasizing the need for judicial resolution of the conflicting public policy considerations can be found than Commissioner Roscoe L. Egger's public remarks on the tax accrual workpapers' issue when the Service's revised manual guidelines were announced in May, 1981. Explaining the reasons for the revisions, Commissioner Egger admitted that:

> We began to hear that our requests for [tax accrual workpapers] were driving a wedge between CPAs and their clients. We heard that situations were being encountered where clients were no longer preparing tax accrual information or were refusing to grant access by the independent auditors since the IRS could then gain access to this information. Ultimately this situation led to the pronouncement by the AICPA's statement on auditing standard 31 on the effect of an inability to obtain evidential matter relating to income tax accrual. This matter also was of concern to the Securities and Exchange Commission since their desire was for full financial disclosure. The CPAs were in a quandry [sic] over this situation since generally accepted auditing standards required a consideration of Federal income taxes. As a result, the AICPA

> formed a special task force on the issue. The subject continued to be one of interest at tax seminars and drew comments in *The Wall Street Journal* and *Business Week* in addition to accounting and tax publications. We in the IRS who are responsible for policy became very concerned because the issue had reached rather emotional proportions and also had real potential for serious negative effects on the quality of financial reporting.

Daily Report for Executives, DER No. 86 (BNA), May 5, 1981, at J-1.*

A former Commissioner of Internal Revenue, Mortimer Caplin, has concluded that:

> The policy arguments for limiting the Service's access to accountants' tax accrual workpapers are persuasive. Candid communication between accountant and client is at stake, as well as protection of the integrity of the financial audit process and the public interest in full disclosure in corporate financial statements. An additional concern is the adverse impact of the tax accrual controversy on the nation's self-assessment system. The federal income tax system is based upon cooperation by the public through voluntary compliance and self-assessment of taxes. To preserve this process, the Service must treat taxpayers in a fair, evenhanded manner, and demonstrate to the public that it is doing so. To this end, the Service depends on the cooperation and backing of both tax lawyers and accountants. It serves the best interests of the Service, therefore, to

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See also Buchholz, *Tax Accrual File Controversy: Legal Problems Facing the Accountant*, 40th Ann. Inst. on Fed. Tax'n § 37.01, at 14-16 (1982); Note, *IRS Access to Tax Accrual Workpapers: Legal Considerations and Policy Concerns*, 51 Ford. L. Rev. 468, 484 (1982); Hanson & Brown, *CPAs' Workpapers: The IRS Zeros In*, 152 J. Accountancy 68 (July 1981); *IRS to Clarify Rules Limiting Agents Probe of Tax Workpapers*, 151 J. Accountancy 8 (May 1981); *Interpretation Guides Auditor Who Cannot Obtain Evidence on Income Tax Accruals*, 151 J. Accountancy 18, 20 (Mar. 1981); Rout, *Auditors Say IRS Demand for Documents is Poisoning Relations with Client Firms*,

(footnote continued on following page)

> treat these professionals with respect and to assist them in resolving problems that relate to administration of the tax law.
>
> Access to tax accrual files certainly is not uppermost among the needs of the Service. It faces problems of a much broader and more pressing nature. Consideration of the proper ranking of Service priorities, especially in light of the policy issues at stake, calls for an institutional effort to defuse the tensions that have developed over the tax accrual issue.

Caplin, *Government Access to Independent Accountants' Tax Accrual Workpapers, supra*, 1 Va. Tax. Rev. at 81-83. (footnotes omitted)

In addition, in May 1980 the Justice Department's Advisory Committee on Tax Litigation, which was investigating standards for seeking accountants' tax accrual workpapers, issued a report in which it recommended that there were "strong policy reasons to be taken into account for" prohibiting summonses for tax accrual workpapers except "in special cases." Justice Department Advisory Committee on Tax Litigation, *Report of the Committee on Standards for Seeking Accountants' Tax Accrual Workpapers, Daily Report for Executives*, DER No. 100 (BNA), May 20, 1980, at J-10, 11. The Justice Department Advisory Committee also suggested that "an enforcement action for tax accrual workpapers" be brought only "where there is a reasonable belief that the workpapers would disclose facts or circumstances relating to a particular transaction or transactions where such facts or circumstances are not otherwise available or apparent through the normal audit procedure." *Justice Department Advisory Committee Report, supra*, DER No. 100, at J-11.

(footnote continued from preceding page)

Wall St. J., Jan. 15, 1981, at 25, cols. 4-6; *A Losing Fight to Shield Company Tax Secrets*, Bus. Week, June 16, 1980, at 117.

B. *The Chilling Effect of Mandatory Disclosure of Tax Accrual Workpapers*

Mandatory disclosure of tax accrual workpapers will have a chilling effect upon the efficacy of the independent auditor's verification of the tax reserve and hence the accuracy of the financial information available to the investing public. The testimony of an accounting expert in *United States* v. *Coopers & Lybrand*, 413 F. Supp. 942 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977), vividly describes the constraints interfering with the accountant's performance of his duty:

> [W]hat I'm concerned about is the ability of the Government to look into the client's mind to determine not what the facts are on which the tax is based, but what the worst possible nightmare is the client can conceive can happen if every assumption on which he based his tax were to go against him in some kind of litigation.
>
> He may think up contingencies even more lurid than the worst contingencies a revenue agent comes up with, and with that information available to the revenue agent just for the asking, I think it would terribly impede and I think eventually destroy the system of auditing that we have established because it would eliminate the freedom that the client feels of being able to muse with us about, well, what if this capital gains is treated as an ordinary income? What are the potentials? What are the chances? Well, the chances are 60-40 or 90-10, one way or the other.
>
> * * *
>
> Now, these are the kinds of problems which we are continually in contact with our client about, are advising the client, are getting his feedback. If we were hampered in any audit situation by the fact that the client knows that if he gives us any data about that that it's going to be readily available to the Government, I cannot imagine how we would be able to render audit opinions for that client for very long. It would just absolutely cut off our communication, and if I were the client, I would be the first to admit that that is the way I would feel.

> I can't see how he can talk to me freely—I'm talking now only about opinions and ideas and thoughts and nightmares, if you will.

(413 F. Supp. at 953-54; *see also* JA 32)

Petitioner argues that the corporate taxpayer's risk of incurring penalties is sufficient to insure compliance with the securities laws. (Pet. Br. at 40-43) This position exaggerates the power of SEC enforcement to encourage complete tax contingency disclosure. It fails to recognize, for example, that the scope of the questions asked, the candor of the answers given and the completeness of the review of supporting records during the independent auditor's verification of the tax reserve can vary "without necessarily violating SEC disclosure requirements." *See* Jacobson & Steel, *The Auditor Work-Product Privilege: The Fifth Circuit Spurns the Second Circuit's Creation of a Novel Privilege*, 16 Rev. of Sec. Reg. 891, 898 (1983).

In *Upjohn Co.* v. *United States, supra*, this Court rejected the same argument petitioner asserts here: "This response ignores the fact that the depth and quality of any investigations to ensure compliance with the law would suffer, even were they undertaken." (449 U.S. at 393 n.2) In *Upjohn*, this Court held that fear of civil or criminal liability would not necessarily lead corporations to conduct thorough internal investigations and seek appropriate legal advice, and concluded that the protection of the attorney-client privilege was needed to provide the requisite, additional incentive. (*Id.*)

Even though most corporations may still try to satisfy fully the disclosure requirements of the securities laws, the risk of discovery by the Service of their planned negotiating positions will lead some to make more conservative and less complete assessments of what tax positions on their return are "questionable." *See generally* Note, *Protecting the Auditor's Work Product from the IRS*, 1982 Duke L.J. 604, 616. As a result, the integrity of the independent auditor's process of verifying the tax reserve during its yearly audit of the corporation's financial statements—which the SEC has described as one of the principal protections for investors

"from inadequate or improper financial reporting" —will be correspondingly diminished. *See* SEC, *Forty-Third Annual Report* 110 (1977).

C. *Standards for Judicial Resolution of Competing Congressional Policies*

Conflicts between competing statutory schemes are grist for the judicial mill. *See, e.g., Watt* v. *Alaska*, 451 U.S. 259, 266-67 (1981). In holding that the antitrust laws must give way to certain self-regulatory provisions of the Securities Exchange Act, for example, this Court ruled:

> As a threshold matter, we believe that the determination of whether implied repeal of the antitrust laws is necessary to make the Exchange Act provisions work is a matter for the courts; . . . .

Gordon v. *New York Stock Exchange*, 422 U.S. 659, 686 (1975) (citing *Ricci* v. *Chicago Mercantile Exchange*, 409 U.S. 289, 306-08 (1973)). Similarly, in *Silver* v. *New York Stock Exchange*, 373 U.S. 341 (1963), this Court recognized that the interrelationship between the antitrust laws and the securities laws "must be discerned as a matter of implication" and statutory construction, the traditional techniques of interpretation which courts have regularly employed. (373 U.S. at 357)

Ignoring these established principles, petitioner emphasizes the general rule of construction that the judiciary should give effect to all federal statutes so long as they are "capable of coexistence." (Pet. Br. at 44) (citing *Regional Rail Reorganization Act Cases*, 419 U.S. 102, 133-34 (1974)) The general rule, however, is of little assistance in this case, which turns on an unavoidable clash between the securities and internal revenue laws.

Petitioner also misconstrues *St. Regis Paper Co.* v. *United States*, 368 U.S. 208 (1961), as supporting its contention that, absent specific statutory provision mandating confidentiality of tax accrual workpapers, they must be produced pursuant to a summons by the Service. In *St. Regis* this Court held that a confidentiality provision in the Census Act, § 9(a),

13 U.S.C. § 9(a), did not preclude enforcement of a disclosure request by the Federal Trade Commission. (368 U.S. at 217-19)

St. Regis is inapposite not only because the disclosure request was not addressed to a third party but also because the census data at issue consisted of facts, not thought processes disclosing a company's position for negotiations with a government agency. Thus, there was little or no risk of a chilling effect undermining enforcement of the Census Act and justifying the creation of a new privilege. (368 U.S. at 216-18) Moreover, in *St. Regis* this Court did not have to tip the balance between competing congressional policies because it found no potential conflict. (*Id.* at 218-20)

Petitioner also fails to recognize the fallacy of its own reasoning that if there is a conflict of congressional policies, it should be resolved by Congress, not the judiciary. (Pet. Br. at 43-44) If this Court resolves the conflict in congressional policies by enforcing the summons, as sought by petitioner, the judiciary rather than Congress will still be making the policy choice—this time in favor of the Service. Petitioner does not really disagree with the source of the decision, but rather with the resolution of the conflict made by the Court below.

D. *The Lower Court's Resolution of the Competing Legislative Policies*

Faced with the clash of congressional policies, the Court below recognized a qualified privilege to protect the work of independent auditors in preparing tax accrual workpapers. (PA 30a, 31a) Congress expressly authorized judicial creation of new privileges under these circumstances in Fed. R. Evid. 501: "the privilege of a witness . . . shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience." (Pub. L. No. 93-595, 88 Stat. 1926

(1975))* These privileges become part of the common law and, as in *Upjohn*, "serve to limit the scope of the IRS' power." (PA 28a) (citing *Upjohn Co. v. United States, supra*, 449 U.S. at 398-99; *United States* v. *Euge, supra*, 444 U.S. at 714) Petitioner's criticism of the decision below ignores Fed. R. Evid. 501. Fed. R. Evid. 501 is the complete answer to the argument of the dissenting opinion in the lower Court that the issue of privilege should be left to Congress. (PA 33a-34a) Congress has authorized the courts to decide that issue.

1. *Fed. R. Evid. 501*

Prior to the enactment of the Federal Rules of Evidence, all privileges in the federal courts had been either created or adopted by the judiciary in the course of resolving conflicting policies favoring and discouraging disclosure of information sought to be protected. *See, e.g., United States* v. *Nixon*, 418 U.S. 683, 708 (1974) (presidential communications are presumptively privileged because of chief executive's need to be "free to explore alternatives in the process of shaping policies and making decisions and to do so in a way many would be unwilling to express except privately"); *Wolfle* v. *United States*, 291 U.S. 7 (1934) (privilege protecting the marital relationship); *Hickman* v. *Taylor, supra*, 329 U.S. 495 (recognizing attorney's work-product privilege).

This Court has observed that in enacting Fed. R. Evid. 501, Congress "manifested an affirmative intention not to freeze the law of privilege" but rather to " 'provide the courts with flexibility to develop rules of privilege on a case-by-case basis' and to leave the door open to change." *Trammel* v. *United States*, 445 U.S. 40, 47 (1980) (quoting statement of Rep.

* The language of Rule 501 was drawn from then existing Fed. R. Crim. P. 26, which provided that the privilege of a witness was governed by the common law as interpreted "in the light of reason and experience." Fed. R. Crim. P. 26 was relied upon as a congressional invitation to the courts to create or modify privileges based on modern circumstances. *See, e.g.*, Mullen v. United States, 263 F.2d 275 (D.C. Cir. 1958) (priest-penitent privilege); In re Verplank, 329 F. Supp. 433 (C.D. Cal. 1971) (expansion of physician-patient privilege).

Hungate at 120 Cong. Rec. 40891 (1974)); *see also Upjohn Co.* v. *United States*, *supra*, 449 U.S. at 396-97; *United States* v. *Gillock*, 445 U.S. 360, 367 (1980).

The legislative history of Fed. R. Evid. 501 confirms "that Congress anticipated future recognition, by the courts, of privileges not recognized at the time of passage of the Rule." Garbis & Struntz, *The Second Circuit's Arthur Young Decision: A Privilege for Tax Accrual Workpapers*, 57 J. Tax'n 66, 68 (1982); *see* S. Rep. No. 1277, 93d Cong., 2d Sess. 12-13 (1974); 2 D. Louisell & C. Mueller, *Federal Evidence* § 200 (1978); 23 C. Wright & K. Graham, *Federal Practice and Procedure: Evidence*, § 5425 (1980).

Under Rule 501's "reason and experience" standard, federal courts have created or expanded some privileges and have rejected or narrowed others based on a balancing of competing disclosure policies.* This Court, for example, declined to create a new privilege where it found that no important policy supersedes the right of the public to "everyman's evidence." *See United States* v. *Gillock*, *supra*, 445

*For decisions creating or modifying privileges, *see* In re Subpoena Served upon Zuniga, No. 82-1906, Slip Op. (6th Cir. Aug. 3, 1983) (qualified psychotherapist-patient privilege); Gray v. Board of Higher Educ., 692 F.2d 901 (2d Cir. 1982) (votes of college tenure committee); In re Grand Jury Matter, 673 F.2d 688 (3d Cir.), *cert. denied sub nom.* United States v. Doe, ___U.S.___, 103 S. Ct. 375 (1982) (adverse spousal testimony); United States v. Green, 670 F.2d 1148 (D.C. Cir. 1981) (narcotics surveillance location); Riley v. City of Chester, 612 F.2d 708 (3d Cir. 1979) (newspaper reporter's sources); In re Agosto, 553 F. Supp. 1298 (D. Nev. 1983) (parent-child communications); O'Connor v. Chrysler Corp., 86 F.R.D. 211 (D. Mass. 1980) (self-evaluation of affirmative action plans). For decisions rejecting new privileges, *see, e.g.*, Memorial Hospital v. Shadur, 664 F.2d 1058 (7th Cir. 1981) (hospital disciplinary proceedings); American Civil Liberties Union v. Finch, 638 F.2d 1336 (5th Cir. 1981) (records of state commissions); Gannet v. First Nat'l State Bank, 546 F.2d 1072 (3d Cir. 1976), *cert. denied*, 431 U.S. 954 (1977) (attorney's escrow accounts); Kaufman v. Edelstein, 539 F.2d 811 (2d Cir. 1976) (expert witnesses); In re International Horizons, Inc., 689 F.2d 996 (11th Cir. 1982) (accountant-client privilege in bankruptcy proceedings); Ott v. St. Luke Hospital, 522 F. Supp. 706 (E.D. Ky 1981) (medical peer review committees).

U.S. at 360 (speech and debate privilege for state lawmakers).

But where—as here—critical policy objectives favoring confidentiality in the decision-making process would be compromised by public disclosure, this Court has not hesitated to tip the balance of competing interests in favor of confidentiality by recognizing a qualified privilege. *See, e.g., United States* v. *Nixon, supra*, 418 U.S. at 683; *see also Kerr* v. *United States*, 426 U.S. 394, 405 (1975) (disclosure would "chill the free and uninhibited exchange of ideas" within a state's prison-parole system). The lower federal courts have utilized a similar balancing process in creating new privileges pursuant to Fed. R. Evid. 501. In *EEOC* v. *University of Notre Dame DuLac*, the Court of Appeals for the Seventh Circuit, announced a qualified academic freedom privilege prohibiting disclosure of the names or identities of persons participating in the peer review process on the ground that the need for "frank and unrestrained critiques and discussions" was paramount in the circumstances. *Daily Labor Reporter*, DLR No. 166 (BNA), D-1, D-3 (7th Cir. Aug 17, 1983). Another federal court, deciding a class action securities fraud suit, recognized a new limited privilege protecting the work of a special officer, an attorney, retained by the corporation to investigate questionable accounting and auditing practices which had led to an SEC complaint. *In re LTV Securities Litigation*, 89 F.R.D. 595 (N.D. Tex. 1981). Like the Court below, these courts recognized new qualified privileges after weighing plaintiff's right to discovery against a competing congressional policy encouraging defendant to take steps to ensure compliance with applicable laws.*

2. *The Analogy to the Attorney's Work-Product Privilege*

Contrary to petitioner's view (Pet. Br. at 11, 29-36), the lower Court was not attempting to create a privilege that

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* *See also* Note, *The Privilege of Self-Critical Analysis*, 96 Harv. L. Rev. 1083 (1983); Murphy, *The Self-Evaluative Privilege*, 1982 J. Corp. L. 489, 491-92 (1982); McClain v. Mack Trucks, Inc., 85 F.R.D. 53 (E.D. Pa. 1979) (refusing to permit

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would track the attorney's work-product privilege detail for detail. There is no dispute that, as a general matter, documents generated by independent auditors are not prepared in anticipation of litigation because auditors are not lawyers and, therefore, do not litigate. Petitioner, in effect, contends that there can be no work-product privilege for professionals other than attorneys. That contention begs the question.

The federal courts created the attorney's work-product doctrine to prevent an abuse of the newly liberalized discovery rules. *See generally* Note, *The Work Product Doctrine in Subsequent Litigation*, 83 Colum. L. Rev. 412, 415-419 (1983). The documents at issue in *Hickman*—an attorney's notes of interviews of witnesses—were not "privileged or irrelevant." (329 U.S. at 509) Their protection against disclosure was based on the fact that their "[p]roper preparation . . . is the historical and necessary way in which lawyers act within the framework of our system of jurisprudence to promote justice and to promote their clients' interests." (329 U.S. at 511; *see* PA 28a) "Discovery," as Justice Jackson emphasized in his concurring opinion, "was hardly intended to enable a learned profession to perform its functions . . . on wits borrowed from the adversary." (329 U.S. at 516)

Recognizing that "it is essential that a lawyer work with a certain degree of privacy," this Court in *Hickman* reasoned that if discovery of the attorney's trial preparation materials were allowed

> much of what is now put down in writing would remain unwritten. An attorney's thoughts, heretofore inviolate,

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discovery of affirmative action plan); Stevenson v. General Electric Co., 26 Fed. R. Serv. 2d 574 (S.D. Ohio 1978) (affirmative action plan); Bredice v. Doctors Hospital, Inc., 50 F.R.D. 249, 250 (D.D.C. 1970), *aff'd*, 479 F.2d 920 (D.C. Cir. 1973) (reports and minutes of defendant hospital's staff meetings concerning the death of plaintiff's decedent were protected by a qualified privilege because "[c]andid and conscientious evaluation of clinical practices is a *sine qua non* of adequate hospital care"). *But see* FTC v. TRW, Inc. 628 F.2d 207, 210 (D.C. Cir. 1980); United States v. Noall, 587 F.2d 123, 126 (2d Cir. 1978), *cert. denied*, 441 U.S. 923 (1979).

> would not be his own. Inefficiency, unfairness and sharp practices would inevitably develop in the giving of legal advice and in the preparation of cases for trial. The effect on the legal profession would be demoralizing. And the interests of the clients and the cause of justice would be poorly served.

(329 U.S. at 511)

In *Upjohn* this Court relied on Fed. R. Evid. 501 to apply the attorney-client and work-product privileges in the context of limiting the Service's summons authority. (449 U.S. at 396-97) The documents at issue in *Upjohn* were prepared by counsel in the course of an internal investigation of questionable payments. As is the case with tax accrual workpapers, the investigation in *Upjohn* was an independent effort to evaluate the corporation's record of compliance with particular statutory requirements.

In *Upjohn*, as here, the Service attempted to summon opinion matter rather than factual data. The Service also contended that its own convenience was sufficient grounds for requiring disclosure of the summoned documents. This Court emphatically disagreed, concluding that "a far stronger showing of necessity and unavailability by other means than was made by the government . . . in this case would be necessary to compel disclosure." (*Id.* at 402) Even though the documents at issue—attorneys' memoranda based on interviews with Upjohn employees world-wide—were likely to provide the Service with useful information in an organized, convenient form, this Court emphasized that it was more important to preserve the confidentiality of the attorneys' thought processes recorded in their summaries of these meetings. (*Id.*)

The lower Court recognized the need for the same kind of protection when it created a qualified privilege for tax accrual workpapers to safeguard the public interest against " 'the grave dangers of inaccuracy and untrustworthiness' . . . that would result" in the independent auditing process if such documents "were routinely revealed to the Service." (PA 31a) (quoting *Hickman*, 329 U.S. at 5)

> If the auditor were required to disclose this material, which is not used in the preparation of the taxpayer's return and is not needed by the IRS to determine the correctness of the taxpayer's return, the auditor would probably be inhibited from creating or maintaining such papers as part of a full and frank exchange useful in complying with the taxpaper's obligations under federal securities laws.

(PA 24a-25a) *See, e.g.*, Fishman, *Intentional Destruction of Tax Workpapers: An Analysis of a Relatively Uncharted Area*, 58 J. Tax'n 214 (Apr. 1983); *see generally*, AICPA, Auditing Standards Division, *The Effect of an Inability to Obtain Evidential Matter Relating to Income Tax Accruals*, 151 J. Accountancy 122 (Mar. 1981).

In evaluating the adequacy of a tax reserve the auditor must, in effect, present the best case which the Service might make against the taxpaper. (*See* PA 24a, 30a; JA 31) In this context, the claim that the independent auditor, as an "instrument of public oversight," expects that his thought process will be open to the public (Pet. Br. at 30), is fatuous. Such opinions and speculations do not represent the auditor's "bottom line" judgments but his worst-case imaginings. Accountants are not permitted to disclose them to the public, and the taxpaper is entitled to an expectation of confidential treatment of its communications with the auditor. *See, e.g.*, AICPA *Code of Professional Ethics*, Rule 301 (1973) ("A member shall not disclose any confidential information obtained in the course of a professional engagement except with the consent of the client."). Their forced disclosure would destroy the "integrity and objectivity" which a public accountant needs to maintain his independent relation to his client. AICPA, *Professional Standards*: ET § 52.01 (CCH) (1981) (Code of Ethics).

The fact that the independent auditor's ultimate judgment as to the adequacy of the tax reserve is made public in the audited financial statement does not mean that the entire analytical process on which that judgment is based should be disclosed. An attorney, for example, will make his strategy public as the trial unfolds in the courtroom, but no adversary

is permitted to discover that strategy in advance or the judgments, opinions and thought processes on which it is based.

Petitioner also contends that the disclosure of an independent auditor's tax accrual workpapers should not be prevented, because unlike an attorney's work product, it is "common for accountants to disclose their clients' confidential communications and their own work product in order to demonstrate that they properly discharged their duties to all." (Pet. Br. at 32) The argument is flawed because it relies on cases in which accountants themselves were accused of fraud and opened their books to defend themselves. *Oleck* v. *Fischer*, 623 F.2d 791 (2d Cir. 1980) (accounting firm allegedly prepared a "fraudulently misleading" financial statement); *Herzfeld* v. *Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27 (2d Cir. 1976) (securities purchaser contended that the audit was "materially and knowingly misleading"); *SEC* v. *Geotek*, 426 F. Supp. 715 (N.D. Cal. 1976) (civil action alleging violations of the fraud provisions of the securities statutes).

These cases constitute an exception, not the general rule, with respect to the independent auditor's obligation to respect client confidences. They correspond to the instances in which a lawyer accused of unprofessional conduct or malpractice is permitted to disclose confidential information received from clients. *ABA Model Code of Professional Responsiblity*, DR4-101(C)(4)(1978) ("A lawyer may reveal. . . confidences or secrets necessary to establish or collect his fee or defend himself or his employees or associates against an accusation of wrongful conduct."); *see, e.g.*, *Condon* v. *Petacque*, 90 F.R.D. 52 (N.D. Ill. 1981).

3. *The Limited Scope of the Privilege Created by the Lower Court*

Contrary to petitioner's assertions (Pet. Br. at 11-12, 35-37), the qualified privilege announced by the lower Court is not a broad testimonial accountant-client privilege running afoul of this Court's decision in *Couch* or the decisions of the lower courts following *Couch*. *See, e.g.*, *In re International Horizons, Inc.*, *supra*, 689 F.2d at 1004. Like the attorney's

work-product privilege, the independent auditor's privilege primarily protects "documents and tangible things"—in this case only the tax accrual workpapers of the independent auditor—not all communications between the auditor and client. The protection is also limited to the work product of the independent auditor—not that of the taxpayer. Accordingly, the privilege belongs to the independent auditor—not the taxpayer. In short, the independent auditor's work-product privilege is as different in its rationale and scope as the attorney's work-product privilege is from the attorney-client privilege. Moreover, lower courts have interpreted the decision below not as creating an accountant-client communication privilege but a qualified privilege for that part of an independent auditor's work-product which consists of tax accrual workpapers. *See, e.g., United States* v. *Haller*, 83-1 U.S.T.C. ¶ 9130 (D. Conn. 1983).

Nevertheless, like the attorney's work-product privilege, the independent auditor's qualified privilege necessarily must have some incidental aspects of testimonial immunity. In *Hickman* this Court observed that "forcing an attorney to repeat or write out all that witnesses have told him and to deliver the account to his adversary gives rise to grave dangers of inaccuracy and untrustworthiness. No legitimate purpose is served by such production." (329 U.S. at 512-13) *See, e.g., Yoffe* v. *Keller Industries, Inc.*, 580 F.2d 126, 131 n. 12 (5th Cir. 1978), *cert. denied*, 440 U.S. 915 (1979) (testimonial immunity for attorney's mental impressions and legal theories); *Ford* v. *Philips Electronics Instruments Co.*, 82 F.R.D. 359 (E.D. Pa. 1979); *Bercow* v. *Kidder, Peabody & Co.*, 39 F.R.D. 357, 358 (S.D.N.Y. 1965); *see generally* 8 C. Wright & C. Miller, *Federal Practice & Procedure: Civil* § 2026, at 230-232 (1970). The thoughts, theories, opinions and judgments of the independent auditor with respect to the corporate taxpayer's tax reserve should be protected against disclosure during oral examination to the same extent as the tax accrual workpapers themselves. Otherwise, the protection afforded by the limited privilege would be meaningless.

E. *Congressional Response to the Lower Court's Decision*

Early in his tenure, former Internal Revenue Commissioner Jerome Kurtz proposed that corporate taxpayers identify in their tax returns any items treated in a manner contrary to a known position of the Service. *See* Kurtz & Panel, *Discussion on "Questionable Positions,"* 32 Tax Lawyer 12 (1978). This proposal immediately aroused an indignant public and Congress, *see, e.g.*, 123 Cong. Rec. 20870 (1977) (remarks of Rep. Crane), and no legislative action was taken to implement it. *See* Rankin, *Taxes and Accounting, Issue of Flagging Questionable Tax Items*, N.Y. Times, July 12, 1977, at 43, cols. 1-2. By demanding access to tax accrual workpapers which would flag corporate taxpayers' "questionable positions" for investigation, the Service here, and in a number of other cases, *see* Lyon, *Tax Investigations Revisited*, 29 Tax Lawyer 477, 482 (1975), apparently sought to put into effect through administrative policy former Commissioner Kurtz's suggestions for legislative action.

The Court below responded directly to the Kurtz proposals:

> [W]e are comforted by the knowledge that if Congress feels that this privilege unduly restricts the IRS's authority, it can require that this material be made available, or that taxpayers flag their questionable positions directly on their returns, in line with the suggestions of former Commissioner Kurtz, 32 Tax Law. at 15-16; Cooper, *The Avoidance Dynamic: A Tale of Tax Planning, Tax Ethics, and Tax Reform*, 80 Colum. L. Rev. 1553, 1612 (1980). Procuring tax accrual workpapers under § 7602 seems to us to effectuate Commissioner Kurtz's proposals through the back door.

(PA 31a, 32a)

Congress enacted TEFRA shortly after the judgment below was entered. Subsection (a) of section 6661 imposes a penalty for a substantial underpayment of tax but subsection (b)(2)(B) forgives it to the extent that the underpayment is attributable to items on which the taxpaper can establish that

"there is or was substantial authority for" its position* or (except for tax shelters) "with respect to which the relevant facts . . . are adequately disclosed in the return or in a separate statement attached to the return". Corporate taxpayers such as Amerada who seek and act on expert advice may well take positions which the Service will successfully challenge but which nevertheless fall within the purview of section 6661(b)(2)(B).

In enacting TEFRA, Congress must be deemed to have been aware of the decision below and the revised guidelines of the Service's Manual which impose restrictions on examiners' authority to summon tax accrual workpapers. *See Herman & MacLean* v. *Huddleston*, _____U.S._____, 103 S. Ct. 683, 689 (1983) (failure of Congress, in making substantial revisions in the securities laws, to amend certain overlapping remedial provisions of those laws, held to constitute ratification of well-established judicial interpretation of the provisions at issue); *see also Bob Jones University* v. *United States*, _____U.S._____, 103 S. Ct. 2017, 2033 (1983).

If Congress intended to require routine disclosure of an independent auditor's tax accrual workpapers or to eliminate or curtail the qualified privilege the Court below created, the 1982 revision of the tax laws provided an excellent opportunity to do so expressly. Congress did not seek to accomplish either objective. Instead, it chose to create a new, voluntary incentive to encourage taxpayers' full compliance with the Internal Revenue Code's reporting provisions. It also recognized that taxpayers should not be penalized for adopting positions which, while contrary to the Service's ultimate determination, rest on a sound legal foundation.

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*The Senate Finance Committee stated that the taxpayer could establish that there is or was substantial authority supporting its position by "showing good faith reliance on a professional opinion that [it] was more likely than not ultimately to prevail in any contest with the Internal Revenue Service." S. Rep. No. 494, 97th Cong., 2d Sess. 273 (1982) ("Senate Report No. 494"). *See also* 26 U.S.C. § 6661(b)(2)(B).

Section 6661 encourages disclosure of the relevant facts relating to "questionable positions" taken by taxpayers; it does not require disclosure of their judgments, doubts and uncertainties about possible tax liability. The statutory scheme also does not enlist public accountants as a new enforcement arm of the Service. As the Senate Report emphasized: "the Committee intends that the Secretary shall in no event require disclosure of accountants' workpapers." Senate Report No. 494, *supra*, at 274.*

Petitioner ignores the new provisions of TEFRA and insists that routine access to tax accrual workpapers is authorized by section 7602. Under petitioner's interpretation of section 7602, the Service had the authority to summon tax accrual workpapers and therefore force corporate taxpayers to disclose all their questionable positions long before TEFRA was enacted. This position, however, is untenable. Congress's adoption of section 6661 confirms that it did not believe that section 7602 by itself permitted the Service to require routine disclosure of "questionable" positions taken on a return by summoning tax accrual workpapers. When Congress decided to create a statutory scheme to encourage, rather than require, disclosure of questionable positions, it did so explicitly and with provision for good faith disputes.

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*The Conference Report accompanying TEFRA replaced the explicit language of the Senate Committee's Report with a brief direction to the Commissioner to prescribe the form of disclosure under "generally applicable regulatory authority." Conf. Rep. No. 760, 97th Cong. 2d Sess. 575-76 (1982). The proposed regulations, issued on March 15, 1983, shed further light on Congress's intent. The regulations set forth guidelines for the type of disclosure required under section 6661. They make no mention of requiring disclosure of accountants' workpapers. 48 Fed. Reg. 10862 (1983) (to be codified at 26 C.F.R. pt. 1). Moreover, the Service also recently issued a Revenue Procedure that further limits disclosure requirements by listing a series of exceptions to the proposed rule. Rev. Proc. 83-21, I.R.B. 1983-13, Fed. Tax Rep. (CCH) § 6457 (1983) In such circumstances, the Service considers a properly completed return, without reference to section 6661 and without further explanation, to be adequate disclosure. (*Id.*)

Consequently, it is petitioner, not respondents, who seeks a judicial modification of the Internal Revenue Code. Petitioner is attempting to enforce a summons for tax accrual workpapers for the purpose of compelling disclosure of the taxpayer's and its auditor's judgments and opinions—not facts—concerning Amerada's alleged "questionable positions on its returns." (Pet. Br. at 13, 43-44) This far exceeds the scope of section 7602 summons authority as limited by Congress in enacting section 6661.

F. *The Service's Recognition of the Rationale of the Decision Below*

Petitioner's position that disclosure of an independent auditor's tax accrual workpapers is essential to the Service's task of "insuring compliance with the tax law" (Pet. Br. at 27) cannot be reconciled with the Service's 1981 revised guidelines for requesting tax accrual workpapers. 1 [Audit] *Int. Rev. Man.* (CCH) § 4024.4 (May 14, 1981).*

The revised guidelines require that, among other things, the following steps be taken before an examiner can consider requesting an independent auditor's tax accrual workpapers:

(1) the examination must be substantially completed;

(2) specific issues must be identified for which there exists a need for additional facts;

(3) all facts known to the taxpayer relating to the identified issues must be sought from the taxpayer in the first instance; and

(4) any supplementary analyses (not necessarily contained in the workpapers) of facts relating to the identified issues must be requested from the taxpayer's accountants.

(revised IRM § 4024.4(1), (2)) Only after these steps have been taken and the examiner determines that a need still exists to inspect the tax accrual workpapers can he seek written approval of his request by the Chief of the Examination Division. (revised IRM § 4024.4(5)) Even then, however, the

*The relevant provisions of the revised guidelines are set forth in Appendix B.

examiner's request will be "limited to those portions of the tax accrual workpapers that are material and relevant and related to the specific issue or issues identified." (Remarks of Commissioner Egger, *Daily Report for Executives*, DER No. 86 (BNA), *supra*, at J-1; *see* revised IRM § 4024.4(3)) Moreover, contrary to petitioner's admissions regarding the Service's purpose in summoning the tax accrual workpapers (*see* discussion *supra* at pp. 7-8), the director of the Service's Examination Division advised all technical personnel and managers in 1980 that the "examiner's interest in the 'items' that make up the tax accrual does not include the independent accountant's or taxpayer's opinion of the value of issues or the likelihood of success in litigation. . . ." *IRS Information Notice* 80-7 (Aug. 4, 1980) (issued by Mr. John L. Wedick, Jr.)

In effect, the Manual's instructions to examiners accord a qualified work-product privilege status to tax accrual workpapers. They require the Service to show a special need for the information contained in those documents by identifying "specific issues" and exhausting reasonable efforts to secure any needed factual information from other sources. The guidelines emphasize that the primary source of factual data is the taxpayer's records and that tax accrual workpapers are to be sought only when the facts relating to identified issues are not available from taxpayer records or supplementary analyses of facts prepared by the accountant. (revised IRM § 4024.4(1))

If the Service in other cases follows its own instructions to examiners and exhausts alternative sources of factual information, it will be in a position to overcome the qualified privilege announced by the lower Court. (PA 31a) Accordingly, the decision below has done little more than give effect to the Service's own guidelines.

Petitioner attempts to gloss over the revised guidelines. (Pet. Br. at 14-15 n.) While the guidelines strictly may not apply to this case,* petitioner advances no reason for ignoring

*The guidelines became effective after the summons for the tax accrual workpapers had been issued.

the Service's own decision to protect tax accrual workpapers against disclosure except in "unusual circumstances." (revised IRM § 4024.4) It appears that the Service is unwilling to abide by its own guidelines.* Judicial resolution of the conflicting public policy issues at stake in this case is required precisely because petitioner has chosen to press this as its test case for establishing the Service's power of unlimited discovery under 26 U.S.C. § 7602.

II.

THE DECISION BELOW MAY BE AFFIRMED ON ALTERNATIVE GROUNDS: THE TAX ACCRUAL WORKPAPERS ARE NOT RELEVANT TO A CIVIL AUDIT AND DO NOT CONTAIN PURELY FACTUAL DATA WITHIN THE SCOPE OF SECTION 7602

A party is entitled "to urge any grounds which would lend support to the judgment below," and this Court may consider them even if they were rejected by the lower court. *Dayton* v. *Board of Education*, 433 U.S. 407, 419 (1977); *see United States* v. *New York Telephone Co.*, 434 U.S. 159, 166 n.8 (1977).

A. *Relevance to a Civil Audit*

1. *The Proper Standard of Relevance*

The standard of relevance to be applied in enforcing section 7602 summonses has not been determined by this Court. In the absence of a definitive rule, the Court below invoked a "low threshold [test] of relevance" in holding that the tax accrual workpapers were subject to a section 7602 summons. (PA 27a) The majority concluded that "it is difficult to say

*Some district courts have permitted this inconsistency by ruling that the guidelines are non-binding, informal instructions to examiners which the Service is free to follow or ignore as it deems appropriate. *See, e.g.* United States v. I.C. Industries, Inc., 555 F. Supp. 219, 222 (N.D. Ill. 1983); United States v. Price Waterhouse & Co., 515 F. Supp. 996, 999 (N.D. Ill. 1981); United States v. Arthur Andersen & Co., 474 F. Supp. 322, 331 (D. Mass. 1979), *appeal dismissed as moot*, 623 F.2d 720 (1st Cir. 1980), *cert. denied*, 449 U.S. 1021 (1981).

that the assessment by the independent auditor of the correctness of positions taken by the taxpayer in [his] return would not throw 'light upon' the correctness of the return." (PA 27a) (quoting *Foster* v. *United States*, 265 F.2d 183, 187 (2d Cir.), *cert. denied*, 360 U.S. 912 (1959)); *see also United States* v. *El Paso Co.*, *supra*, 682 F.2d at 537. ("It is, in fact, hard to imagine a document more likely to shed light on the correctness of those aspects of a return that harbor doubts than the tax pool analysis").

The lower Court's gloss on the meaning of "relevance" for purposes of section 7602 is in direct conflict with the decision of the Court of Appeals for the Tenth Circuit in *United States* v. *Coopers & Lybrand*, *supra*, 550 F.2d at 618, which held that an accountant's tax accrual files were not "relevant" to a tax investigation. Like the tax accrual workpapers here, the files in *Coopers & Lybrand* had been prepared solely for SEC and financial reporting purposes and not in connection with the taxpayer's return. (550 F.2d at 621)

In holding the tax accrual workpapers not relevant, the Court of Appeals for the Tenth Circuit relied in part on *United States* v. *Matras*, 487 F.2d 1271 (8th Cir. 1973), which denied enforcement of a Service summons for certain corporate budget forecasts. The Court in that case admonished that "the government should not, for the mere sake of its convenience, impose unnecessary burdens on a taxpayer in conducting an audit or investigation for tax liability, particularly where, as here, there is no indication of a purpose to escape any tax liability." (487 F.2d at 1275)

In *Coopers & Lybrand*, the Court recognized that the summoned tax pool analysis could assist the Service in its audit. Nevertheless, it held that "[m]ere convenience does not make an item producible under an IRS summons." (550 F.2d at 621) (relying on *Matras*) The Court emphasized that "extending IRS contentions . . . to their logical conclusion, it is hard to determine what corporate records would not fall under a § 7602 summons if the standard endorsed the production of *any* records which *might* show tax fraud or tax liability. IRS does not . . . have *carte blanche* discovery."

(550 F.2d at 619)* As a result, in *Coopers* v. *Lybrand* the Court held that the Service could not satisfy its burden of showing relevance "by alleging a general need for a 'road map' " revealing the soft spots in the return as detected by the taxpayer and its accountant. (*Id.*)

The Court below erred in not applying the stricter relevance test developed by the Eighth and Tenth Circuits. Enforcement of a Service summons should require a showing of "sufficient relevance"—not relevance in the abstract. *United States* v. *Harrington*, 388 F.2d 520, 523-24 (2d Cir. 1968). The "might-have-thrown-light-on-the-correctness-of-the-return" shibboleth is only the beginning of the relevance inquiry—not the entire analysis. The relevance test, for purposes of section 7602, should not always be a "low threshold." (PA 27a) Rather, it should be a matter of judgment and degree in light of the particular circumstances of the case. (388 F.2d at 524); *see generally*, Caplin, *Government Access to Independent Accountants' Tax Accrual Workpapers, supra*, 1 Va. Tax Rev. at 64-65.

The particular circumstances which must be taken into account in the determination of relevance include the degree of intrusion into a third party's files, the type of materials requested and a balancing of public policies with respect to disclosure. *See* Note, *A Balancing Approach to the Discoverability of Accountants' Tax Liability Workpapers Under Section 7602 of the Internal Revenue Code*, 60 Wash. U.L.Q. 185, 203-04 (1982).

For example, when a third-party summons (such as the one at issue) is involved, the Service must show something "of particularity concerning" its investigation—some reference to a "transaction which might possibly afford the realistic expectation necessary"—in order to obtain the requested

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*The Justice Department Advisory Committee on Tax Litigation reported that its members "agree with the decision in *Coopers*. All of the members of the Committee believe that if the IRS were to prevail in such a situation there would be no effective restraint against a 'fishing expedition' by the IRS." *Report by Justice Dep't Advisory Committee on Standards for Seeking Accountants' Tax Accrual Workpapers, supra*, DER No. 100, at J-10.

documents. *United States* v. *Goldman*, 637 F.2d 664, 667 (9th Cir. 1980), *aff'g* 453 F. Supp. 508, 512 (C.D. Cal. 1978); *United States* v. *Harrington*, *supra*, 388 F.2d at 523 (relevance for purposes of section 7602 requires a "realistic expectation rather than an idle hope that something may be discovered"). *See United States* v. *Powell*, *supra*, 379 U.S. at 57-58 (in order to meet its burden, the Service must specify how the requested documents relate to the "purpose of the investigation"); *United States* v. *Wyatt*, 637 F.2d 293, 301 (5th Cir. 1981) (relevance established by testimony of agent who not only gave "examples of the types of transactions to which the [Service's eleven] questions were directed and how such transaction would affect the taxpayer's income tax liabilities but detailed the need of the discovery and explanation of reported and unreported transactions.")*

The appropriate standard of relevance also depends on the nature of the documents summoned by the Service. The District Court in *Coopers & Lybrand* determined that when the "data sought are not records of transactions" or information "customarily . . . maintained in support of company transactions" but rather—as here—the "private thoughts and theories of the taxpayer" and its independent auditor, "the courts are prone to press the Service to a higher standard of relevance." (413 F. Supp. at 950). The Court concluded that the Service had failed to show that there was a "sufficient nexus between the information requested and the purpose for which it is summoned." (413 F. Supp. at 954). *See United States* v. *El Paso Co.*, *supra*, 682 F.2d at 548 (Garwood, J., dissenting) (in the context of a summons for an internal auditor's tax accrual workpapers, the relevance test of "throw light upon" means "throw *factual* light upon"); *United States* v. *Matras*, *supra*, 487 F.2d at 1272-73; *United States* v. *Luther*, 481 F.2d 429, 433 (9th Cir. 1973). In each of these decisions, it was the type of materials at issue—primarily

* Congress's special concern with third-party summonses is apparent from the procedural rights granted in section 1205 of the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1699-1702, *amending* 26 U.S.C. § 7609. *See generally* S. Rep. No. 938, 94th Cong., 2d Sess. (1976).

projections, opinions, hypotheses of the taxpayer—which determined whether they were encompassed by section 7602.*

Finally, unlike the Court below, some courts have taken into account the various public policies affecting disclosure before determining relevance for purpose of section 7602. For example, in *Coopers & Lybrand*, the Court of Appeals for the Tenth Circuit considered the adverse effects of disclosure of tax accrual files upon the independent auditor-client relationship. (*See* 550 F.2d at 620 and 413 F. Supp. at 948-49) (*See* discussion *supra* at pp. 15-20) By applying a stricter standard of relevance, the Court in *Coopers & Lybrand* and other courts sought to balance the Service's need for information, the investing public's dependence on accurate financial reporting and the accountant's interest in safeguarding the confidentiality of his work product. *See also United States* v. *Arthur Andersen & Co.*, *supra*, 623 F.2d at 729 (determination of "relevance" should involve a "resolution sensitively reflecting the legitimate interests" of "all concerned—taxpayers, accountants, and IRS"—which would be "faithful to applicable statutes" and "would involve the most delicate and demanding analysis of facts, research of law and reflection on policy").

Similarly, in *United States* v. *Williams*, 337 F. Supp. 1114 (S.D.N.Y. 1971), *appeal dismissed and vacated*, 486 F.2d 1397 (2d Cir. 1972), the District Court held that a pyschologist's patient's message slips did not have to be produced even though they were held to be of "marginal relevance" because "of a burden on third parties that use of the requested message slips will impose." (337 F. Supp. 1116-17) In so ruling, the Court emphasized that mandatory disclosure of the summoned documents to the Service would interfere with the free flow of confidential information necessary for the conduct of a professional relationship. *See generally*, Note, *Government Access to Corporate Documents and Auditors'*

* In P.T.&L. Constr. Co. v. Commissioner, *supra*, the Tax Court held with respect to taxpayer discovery of the Service: "[w]hat is relevant is the *factual* information. . . . Mental impressions, legal analysis, conclusions and recommendations are generally not relevant." (63 T.C. at 414)

Workpapers: Shall We Include Auditors Among the Privileged Few?, 2 J. Corp. L. 349, 384-85 (1977). These broader policy concerns are particularly apparent in this case, which not only involves a burden to a particular taxpayer and a third party, but which will also have broad implications for all taxpayers and the accounting profession.

The Service itself has recognized in its revised guidelines that a routine civil audit does not require examination of tax accrual workpapers. In fact, the Internal Revenue Manual's requirement that the Service identify "specific issues" under investigation is an administrative analogue to the *Harrington* tests of "sufficient relevance" and "reasonableness" (388 F.2d at 523, 525). *See* 1 [Audit] *Int. Rev. Man., supra*, § 4024.4.

2. *Application of the Proper Relevance Standard to this Case*

Section 7602 provides that the Service can summon "any books, papers, records or other data" which "may be relevant or material" to "such inquiry," that is, "[f]or the purpose of ascertaining the correctness of any return" or "determining the liability of any person for any internal revenue tax." Congress's use of the term "inquiry" in section 7602 refers to the "subject matter inquired about rather than the process or performance of investigation to elicit the correct answer to the question." *United States* v. *El Paso Co., supra*, 682 F.2d at 546 (Garwood, J., dissenting). Accordingly, section 7602 requires a showing of "potential relevance to the *correctness* of a return or the *liability* of any person for a tax, as opposed to those [documents] the Service seeks merely because they have the potential of facilitating or making more efficient the process of examination." (*Id.* at 547) The Service here, as in *El Paso*, "clearly seeks the tax pool analysis for the latter purpose, not the former." (*Id.*)

That the tax accrual workpapers lack potential relevance to a civil audit, which the Court below assumed they have, is underscored by this Court's admonition in *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522 (1979), that "any presumptive equivalency between tax and financial accounting would be unacceptable.... Financial accounting ... is

hospitable to estimates, probabilities and reasonable certainties; the tax law . . . can give no quarter to uncertainty." (*Id.* at 543) The tax accrual workpapers are based on financial, not tax, accounting principles and thus have no specific relevance to the correctness of the return. (*See* discussion *supra* at pp. 2-3)

The Court below erred in not requiring the Service to demonstrate that it had a "realistic expectation" that the tax accrual workpapers bore a "sufficient relationship" to the correctness of Amerada's tax returns. *United States* v. *Harrington*, *supra*, 388 F.2d at 525. The Service relied on the affidavits of four employees, who recited only the theoretical relevance that the tax accrual workpapers might have to Amerada's tax liability. (*See* JA 11, 55, 57, 59, 98, 108) Under the "sufficient relevance" and "realistic expectation of relevance" tests, however, more is required. The Service's affidavits do not establish the requisite nexus between the independent auditor's tax accrual workpapers and the correctness of Amerada's returns.

B. *The Absence of Purely Factual Data*

The summons at issue raises a fundamental question of statutory construction: are the tax accrual workpapers included among the papers discoverable under section 7602?

Section 7602(1) permits the Service to summon "books, papers, records, or other data." The issue of what is meant by the generic term, "other data," in section 7602 was raised but not resolved by this Court in *United States* v. *Euge*, *supra*. No precise definition of the types of documents covered by section 7602 is provided in the Internal Revenue Code or its legislative history.* *See, e.g., United States* v. *Davey*, 543 F.2d 996, 1000 (2d Cir. 1976); *United States* v. *Brown*, 536 F.2d 117 (6th Cir. 1976). However, there is no indication in the legislative history of the Internal Revenue Code of 1954, its statutory predecessors, or regulations of the Service that the phrase, "books, papers, records, or other data," was

*The legislative history of section 7602 is examined in United States v. LaSalle Nat'l Bank, 437 U.S. 298, 310-311 (1978). *See* H.R. Rep. No. 1337, 83rd Cong., 2d Sess. 436 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 617 (1954).

intended by Congress to include the kind of judgmental, evaluative material contained in the tax accrual workpapers. *See* Caplin, *Should the Service Be Permitted to Reach Accountants' Tax Accrual Workpapers?*, *supra*, 51 J. Tax'n at 199; Diss, *The IRS and Auditors' Tax Workpapers: How Much is Too Far?*, Arthur Young J. 10, 18 (Summer/Autumn 1976).

The class of documents subject to discovery under 7602 must constitute "data" which, under either generally accepted usage or legal definition, means *factual* material.* No matter what the Service claims, the projections, hypotheses, speculations and private thought processes contained in the tax accrual workpapers do not consist of factual material.**

**See Webster's Collegiate Dictionary* 210 (1971) ("factual material used as a basis . . . . for discussion or decision"); *Black's Law Dictionary* 356 (5th ed. 1979) ("facts from which to draw a conclusion").

**This suggested construction of section 7602 finds substantial support within the Internal Revenue Code. Congress apparently intended to relate the section 7602 summons, section 7604 enforcement, section 7609 notification and section 7610 expense reimbursement provisions to the books of account and records which sections 446 and 6001 require to be maintained by taxpayers. *See* Diss & Hanson, *Tax Contingency Audit Workpapers: Current Developments, Observations and Proposals*, 12 Tax Adviser 104, 109 (1981); Diss, *The IRS and Auditors' Tax Workpapers: How Far Is Too Far?*, *supra*, Arthur Young J. at 18.

Sections 446 and 6001 and the accompanying regulations require the taxpayer to maintain permanent books of account and records sufficient to establish its taxable income, deductions, credits and other matters required to be reported on its income tax return. 26 C.F.R. §§ 1.446-1(a)(4) (1982); 1.6001-1(a) (1980). Moreover, district directors of the Service are empowered to require, by prior notice, that specific records be maintained to enable them to determine tax liability. 26 C.F.R. § 1.6001-1(d) (1980). Where no particular form of required records is specified, the records retained by the taxpayer must enable the district director to ascertain tax liability. *See, e.g.*, 26 C.F.R. § 1.6001-1 (1980) (employment tax records). Indeed, 26 U.S.C. § 7609(c)(3), which defines materials subject to a third-party summons, uses the term "records" to include "books, papers, or other data."

CONCLUSION

The decision below should be affirmed.

Respectfully submitted,

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September 9, 1983

APPENDIX A
AMERADA HESS CORPORATION

Subsidiaries (Not Wholly Owned) and Affiliated Companies

1. Anglomar Shipping Company Ltd.
2. Ariadne Co. L.P.
3. Artemis Marine Co. L.P.
4. Atlas Marine Co.
5. Bushehr Petroleum Co.
6. Conmar Terminals, Ltd.
7. D'Ippolito Oil Co.
8. Esperanza Petroleum Corp.
9. First United Shipping Corp.
10. Grandreunion Co.
11. Interocean Tanker Corp.
12. Matco Tankers (U.K.) Ltd.
13. Meadville Corp.
14. Oasis Oil Company of Libya, Inc.
15. Reserve Terminal Corp.
16. Second Reserve Terminal Corp.
17. Second United Shipping Corp.
18. Solar Gas, Inc.
19. South Jersey Terminal Corp.
20. St. Croix Petrochemical Corp.
21. Third United Shipping Corp.
22. Wyatt, Inc.

APPENDIX B

Internal Revenue Manual § 4024.4 (May 14, 1981) Guidelines for Requesting Audit or Tax Accrual Workpapers

(1) In unusual circumstances, access may be had to the audit or tax accrual workpapers. However, examiners should keep in mind that the taxpayer's records are the primary source of factual data to support the tax return. Accountants audit or tax accrual workpapers should normally be used only when such factual data cannot be obtained from the taxpayer's records and then only as a collateral source for factual data, access to which should be requested with discretion and not as a matter of standard examining procedure. For example, after the examiner has audited the taxpayer's records regarding the reserve for bad debts he/she may request the *audit* workpapers relating to the reserve for bad debts if those workpapers are determined to be necessary. Such a request should be made first to the taxpayer.

(2) Unusual circumstances, for this purpose exist under the following conditions:

(a) a specific issue or issues has been identified by the examiner for which there exists a need for additional facts; and

(b) the examiner has sought from the taxpayer all facts known to the taxpayer relating to the identified issue(s); and

(c) the examiner has sought from the taxpayer's accountant supplementary analysis (not necessarily contained in the workpapers) of facts relating to the identified issue(s).

(3) In any case where the unusual circumstances in (2) above furnish a basis for requesting audit or tax accrual workpapers, the examiner should limit the request only to the portion of the workpapers believed to be material and relevant to the examination. Whether an item is considered to be "material" is based on the examiner's judgment and an evaluation of the facts and circumstances in the case. However, materiality does not depend entirely on amount. The concept

involves qualitative as well as quantitative judgments. For example, the significance of an item or its impact on the tax liability could be some of the factors to be considered in making a judgment regarding materiality.

(4) The reconciliation of Schedule M-1 must be made before considering whether it is necessary to request tax accrual workpapers. Guidelines for the reconciliation are contained in text 232.8 of IRM 4233, Tax Audit Guidelines, Partnerships, Estates and Trusts, and Corporations.

(5) In situations where it is deemed necessary to request tax accrual workpapers in corporate examinations, the prior written approval of the Chief, Examination Division is required. When requesting information pertaining to the tax accrual, the examiner should first take all reasonable means to secure this information from the corporate officer before looking to the independent auditor to provide the information. This will require the examiner to question and where that is not successful to summons a financial officer or the tax manager of the corporation. See IRM 4024.5 concerning use of summons.

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FILED
SEP 9 1983
ALEXANDER L. STEVAS
CLERK

No. 82-687

IN THE

Supreme Court of the United States

October Term, 1982

UNITED STATES OF AMERICA,

Petitioner,

v.

ARTHUR YOUNG & COMPANY
and
AMERADA HESS CORPORATION,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR RESPONDENT AMERADA HESS CORPORATION

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QUESTION PRESENTED

WHETHER, ABSENT THE MOST COMPELLING OF CIRCUMSTANCES, FUNDAMENTAL FAIRNESS DICTATES THAT THE GOVERNMENT SHOULD BE PRECLUDED FROM PROBING THE THOUGHT PROCESSES OF ITS CITIZENS OR INTRUDING UPON THOSE RELATIONSHIPS ENTERED INTO WITH A SUBSTANTIAL EXPECTATION OF PRIVACY.

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October Term, 1982

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BRIEF FOR ARTHUR YOUNG & COMPANY

PRELIMINARY STATEMENT

As the Internal Revenue Service ("Service" or "IRS") has recognized in its Petition for Writ of Certiorari, this case is of major importance to the accounting and legal professions. Petition for Writ of Certiorari at 7. It is also of critical significance to the effective operation of the federal securities laws and the flow of accurate financial information to the public markets. Finally, it raises issues concerning the extent to which the Government may intrude into the thought processes of its citizens particularly when it is in an adversarial position with them.

In this case the Service seeks unfettered access to certain workpapers created by Arthur Young during its audits of the 1972, 1973, and 1974 financial statements of Amerada Hess Corporation ("Amerada"). These workpapers — Arthur Young's tax accrual file — form the basis for its opinions with respect to the accounting treatment for tax liabilities in Amerada's financial

statements for those years. Tax accrual workpapers contain analyses of the strengths and weaknesses of the client's tax positions, speculation about tax law developments, and conjecture regarding the litigation positions and possible settlement of litigation with the IRS with respect to previously filed tax returns. Contrary to the Government's claim (Pet. Br. at 10, 14-15, 24),[1] the affidavits submitted below unequivocally show that the tax accrual workpapers do *not* contain facts not otherwise available to the Service (JA 31-32 ¶¶26-29; JA 38).

The Service argues that these workpapers would shed light on the taxpayer's state of mind in preparing its returns because the taxpayer may have ignored the accountant's advice (Pet. Br. at 10, 25) — a position which its own brief actually contradicts (*id.* at 23 - tax accrual workpapers relate "to the tax treatment of transactions occuring in *prior* years"). The Service also argues that having access to these papers would make its job easier by providing a road map through the thicket of facts, theories, and tax possibilities (*id.* at 25-26) by highlighting a taxpayer's vulnerabilities (*id.* at 27). In addition, the Service argues that failure to obtain access to tax accrual workpapers might impede tax investigations. (*Id.* at 14). However, other than its *ipse dixit*, the record does not support this bald claim and, in fact, contradicts it. At best, the IRS claim of "need" amounts to no more than the well worn claim of "administrative convenience." The Service now concedes, for the first time and contrary to its prior pronouncements, that its real intent is to discover the thought processes and mental impressions of the taxpayer and the taxpayer's auditor. (Pet. Br. at 10, 26, 27.)

The real focal point of this case is whether the Government has the right to probe both (i) the thought processes of the independent auditor with respect to the reasonableness of the client's provision for tax liabilities in its financial statements and (ii), to the extent they are reflected in the tax accrual work papers, the thought processes of the taxpayer. This latter inquiry, however, is not directed at the preparation of the tax return, a matter as to

1. The following abbreviations are used in this brief: IRS Brief on the Merits ("Pet. Br. at ") and Joint Appendix ("JA").

which the affidavits below show that tax accrual papers are unrelated (JA 32 ¶29), but at the taxpayer's views on *pending* disputes with the Service. Allowing the Service access to these thought processes is no different from allowing an adversary access to an attorney's mental impressions and strategies in the course of litigation—a concept which is alien to the notion of fair play in our judicial system.

There are several critical policy issues at stake in this case including:

(1) balancing the respective needs of the IRS and the investing public,

(2) the appropriateness of a "work product" doctrine for accountants under certain limited circumstances, and

(3) the showing of relevance required of the IRS in a summons enforcement proceeding.

The resolution of each of these issues must be guided by one overriding consideration — fundamental fairness.

In the name of administrative convenience, the IRS seeks the Court's imprimatur on a policy the very effect of which runs counter to the concept of fundamental fairness. Just as this Court sanctioned the creation of the attorney work product doctrine 36 years ago because of concerns of fundamental fairness, so too considerations of fundamental fairness dictate that the protection afforded tax accrual workpapers by the Second Circuit be sanctioned.

As with any subject of such significance, the question of IRS access to tax accrual workpapers has generated substantial commentary. With the exception of one article written by a government attorney,[2] every commentator who has treated the issue agrees that the IRS should be denied access to those papers.[3]

2. Nath, *Internal Revenue Service Summonses for "Sensitive" Accountants' Papers*, 34 VAND. L. REV. 1561 (1981).

3. Buchholz, *Tax Accrual File Controversy Legal Problems Facing the Accountant*, 40 INST. ON FED. TAX'N 37-1 (1982); Caplin, *Should the Service be Permitted to Reach Accountants' Tax Accrual Workpapers?*, 51 J. TAX'N 194 (Oct. 1979); Caplin, *Government*

STATEMENT OF THE CASE

A. The IRS Audit of Amerada's Tax Returns

In 1975 the Service commenced an audit of Amerada's 1972, 1973, and 1974 tax returns. The audit was routine; the Service has audited all Amerada tax returns for many years under what is now called the Coordinated Examination Program ("CEP"). 2 [Audit] INT. REV. MAN. (CCH) § 42(11) *et seq.*

For those large, multinational corporations which are designated for CEP status, the Service has its own office space within the taxpayer's offices, deals on an almost daily basis with corporate personnel and records, and reviews tens of thousands of documents. As a result of a CEP audit, the agents assigned to a taxpayer's audit become quite knowledgeable about the corporate taxpayer, its structure and organization, and its operations.

Access to Independent Accountants' Tax Accrual Workpapers, 1 VA. TAX REV. 57 (1981); Carter, *Protecting the Auditor's Work Product from the IRS*, 1982 DUKE L.J. 604 (1982); Diss and Hanson, *Tax Contingency Audit Workpapers: 1981-1982 Developments, Observations and Proposals*, 14 TAX ADVIDER 154 (1983); Diss, *Background Paper of the Tax Executives Institute on the Confidentiality of Tax Accrual Workpapers*, 27 T.E.I. NEWS 1 (1981); Garbis & Struntz, *The Second Circuit's Arthur Young Decision: A Privilege for Tax Accrual Workpapers*, 57 J. TAX'N 66 (1982); Stoltenberg and Robinson, *Enforcement of Summonses in Requesting Accountants' Workpapers*, 60 TAXES 673 (1982); Valdivia, *Comment-United States v. El Paso Co.: A Shift in Policy Towards IRS Summons of Tax Accrual Workpapers*, 36 TAX LAWYER 835 (1982); Note, *IRS Access to Tax Accrual Workpapers: Legal Considerations and Policy Concerns*, 51 FORDHAM L. REV. 468 (1982); Note, *Auditor-Client Work-Product Privilege With Respect to Tax Accrual File: The Arthur Young Case*, 27 ST. LOUIS U.L.J. 437 (1983); Note, *A Balancing Approach to the Discoverability of Accountants' Tax Liability Workpapers Under Section 7602 of the Internal Revenue Code*, 60 WASH. U.L.Q. 185 (1982); Comment, *The Creation of an Accountant Workproduct Privilege - Rendering Relevancy Irrelevant: United States v. Arthur Young & Co.*, 57 ST. JOHN'S L. REV. 348 (1983). *See also* Report by Justice Department Advisory Committee on Tax Litigation, on Standards for Seeking Accountants' Tax Accrual Workpapers, *Daily Report for Executives (BNA)*, DTA No. 100, at J-10, 11 (May 21, 1980)

But cf. Jacobson & Steel, *The Auditor Work-Product Privilege, The Fifth Circuit Spurns the Second Circuit's Creation of a Novel Privilege*, 16 THE REVIEW OF SECURITIES REGULATION NO. 10 at 13, (May 18, 1983) (critical of legal reasoning, but recognizing legitimate concerns by auditors).

In the audit at issue here the Service made 400 civil document requests to Amerada (JA 86), 398 of which Amerada complied with (*id.*),[4] providing access to "45,000 pages of documents underlying these tax returns" to the Service (JA 65 ¶ 10). The civil document requests ranged from the broad (*e.g.*, JA 70) to the specific (*e.g.*, JA 68-9, 71-2) and covered the gamut of Amerada's operations (JA 64). In addition to document requests, the Service took 36 sworn statements. (JA 96).

Amerada alone expended some 11,500 hours or 6 person years responding to requests by the Service on the audits at issue. (JA 64). By the time the Service sought documents from AY, it had extensive amounts of information in its possession. In fact, it had substantially completed its audit because it had already issued the "proposed civil tax adjustments to Amerada." (JA 103).

B. AY and the Audit Function.

As a public company, Amerada is required to file audited financial statements with the Securities and Exchange Commission. Those audited financial statements are a critical source of information for the investing public in deciding whether to buy or sell Amerada securities. Since 1971, AY has audited the annual financial statements of Amerada. The purpose of an audit is to permit the independent auditor to render an opinion on whether the financial statements have been prepared in accordance with Generally Accepted Accounting Principles ("GAAP") on a basis consistent with prior years. *SEC* v. *Arthur Young & Co.*, 590 F.2d 785, 788 n.2 (9th Cir. 1979). The audit does not determine whether an individual account is correct, but whether the financial statements *taken as a whole* are fairly presented in accordance with GAAP. AICPA, PROFESSIONAL STANDARDS, STATEMENTS ON AUDITING STANDARDS NO. 1.

4. Amerada's unwillingness to comply with the two requests was based on the fact that the materials sought were subject to work product and privilege protection.

In connection with any audit, AY prepares workpapers to reflect the judgments it makes with respect to the financial statements. Audit workpapers are prepared to (i) document compliance with Generally Accepted Auditing Standards ("GAAS"), (ii) facilitate supervision and review of the work, and (iii) provide a record of the work. The workpapers contain a myriad of materials most of which, however, have absolutely no conceivable relevance to a corporation's tax return, let alone its correctness because, as this Court has repeatedly noted, *see, e.g., Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522 (1979), financial accounting and tax accounting are not the same.[5]

The "numbers" in a financial statement are largely the result of complex judgments which management and auditors make about the probable outcome of future events. Philip A. Loomis, Commissioner, Securities & Exchange Commission, Speech, *Current S.E.C. Projects in Accounting and Financial Reporting*, before a Seminar of the Machinery and Allied Products Institute, June 24, 1974, at 5 ("[T]he figures in large part reflect judgments and accounting conventions."). For example, reserves for uncollectible receivables and allocations of cost pools between various entities are estimates for which there are no hard and fast guidelines. (JA 27 ¶ 15-16).

One area of financial accounting requiring the most difficult and sensitive of judgments by the auditor is the tax accrual review, which represents judgments and opinions concerning the existence and timing of the client's tax liability. In that review the auditor considers whether the amount stated in the tax liability account in the financial statements is "materially" correct. (JA 28-32). The tax liability account in the financial statements, which is not the same as the tax liability shown on the tax return, includes, *inter alia*, (i) *estimated* taxes currently due, (ii) *estimated* taxes due in the future (*e.g.*, such as deferred taxes), and

5. *See* Cross-Petition for Writ of Certiorari of Arthur Young & Company, No. 82-837, filed November 19, 1982, pending. (Because financial accounting and tax accounting have "vastly different objectives," 439 U.S. at 542, there is no presumptive relevancy between audit workpapers dealing with financial accounting matters and "ascertaining the correctness" of a tax return.)

(iii) possible provisions for amounts due for disallowances of prior year returns and contested items in the tax court. It is net of refunds due a taxpayer because of the availability of a net operating loss or because of claims for refund which may be currently in litigation with the Service.

The tax accrual analysis is prepared in connection with the annual audit of a corporation's financial statements (ACCOUNTING RESEARCH BULLETIN No. 50) and, as to public companies, is part of the independent auditor's performance of his statutory duties under the Securities laws (*see, e.g.*, REGULATION S-X, Rule 4.08(g), 17 C.F.R. § 210.4-08(g)).

The tax accrual review includes, *inter alia*, the auditor's judgments on:

- whether the IRS is likely to issue a deficiency letter and the likely disposition of that deficiency;
- whether a client will litigate or compromise a disputed tax treatment, and if it intends to compromise, in what amount;
- whether a change in the case law or Service's position occurred after the client's tax return was filed and its effect, if any, on that return;
- whether the IRS might interpret the law or regulations applicable to a transaction in a different manner than does the taxpayer or the courts and the impact of such a treatment;
- whether there exist differences of judgment with respect to the effect of transactions in question; and
- whether a taxpayer's claim for refund is likely to result in a settlement or recovery after litigation.

The Service has characterized from its perspective that portion of the audit process relating to tax accruals:

> Part of the auditing function is to evaluate the sufficiency of the client's reserves to meet its potential tax liability. This evaluation is based in part on the accountant's analysis of corporate records and in part on *its assessment of opinions and projections communicated in confidence by the client*. In reaching its conclusion the accountant considers all uncertain tax positions taken by

> the client and determines the extent of reserves necessary to cover the liability that would result assuming that all such questions were resolved against the client.

1 [Audit] INT. REV. MAN. (CCH) § 4233, ch. 232.8(4), at 7281-22 (emphasis added).

In performing a tax accrual review an auditor needs a thorough understanding of the tax laws, as well as of the company's books and records. Also, the auditor must obtain information through candid discussions with client personnel *as well as* the client's counsel (inside and outside) who may be handling a tax dispute (*e.g.*, in tax court) or advising the client with respect to tax issues. This is an essential part of the audit process. Without frank, open, and candid discussions to obtain the client's views on (i) the underlying transactions, (ii) the issues the company itself believes are, or could be, sensitive in a challenge by the Service, and (iii) management's likely action (*e.g.*, the likelihood of settlement and the amount thereof), completion of an audit in accordance with GAAS might be impossible. *See* AICPA, PROFESSIONAL STANDARDS A.U. § 9326.06, *Evidential Matter: Auditing Interpretations of AU Section 326*, (failure to obtain adequate evidential support for the tax accrual can lead to a scope qualification in the audit). Thus, if the auditor's ability to communicate freely and candidly with management were impaired, the potential for materially misleading financial statements and/or a possible scope qualification in the auditor's report on the financial statements, which is unacceptable to the SEC, would be materially increased.

Significantly, as the affidavits below show, tax accrual workpapers are not used in connection with the preparation of the tax returns and they do not and cannot serve to prove or disprove the "correctness" of a taxpayer's tax return. (JA 28 ¶ 18; JA 32 ¶ 29). In fact, much of the tax accrual review relates to tax returns already filed and tax positions previously taken by the taxpayer and may focus on the possible outcome of *pending* audits and litigation between the Service and taxpayer, all of which are only with respect to returns previously filed. Thus, the Service's position that the tax accrual workpapers will reflect on

the taxpayer's state of mind in preparing the return is specious to the extent that the workpapers are created by the auditors *after* the returns have been prepared (*see, e.g.*, Pet. Br. at 25); and is in fact contradicted by Service's own brief (Pet. Br. at 23 — the tax accrual account "reflects the sum of contingent tax liabilities relating to the tax treatment of transactions occurring in *prior years* that may give rise to possible, but not agreed to, adjustments in the corporation's tax liabilities for those years." (emphasis added).

Thus, the tax accrual papers reflect the opinions and judgments of the auditors about the taxpayer's positions and possible adversary positions of the Service.[6] Were the information in the tax accrual file to be made available to the Service, a company's ability to defend its position or to strike a reasonable settlement would be seriously impaired.[7] The Service would have a

6. Although some of these judgments may be made without regard to the underlying facts, the auditor needs to understand the transactions at issue. To the extent these judgments are based on factual data, the affidavits below unequivocally show that such factual data is otherwise available in the taxpayer's records, elsewhere in the workpapers, or in publicly available documents. (JA 32 ¶ 29, JA 38 ¶ 3)

7. An example of this process involving oil companies is the "Delineation Wells Issue." (Delineation Wells are used to determine the location of an offshore oil and gas reservoir.) The Service has uniformly disallowed Delineation Well costs. In a test case before the Tax Court, *In re Standard Oil Co. (Indiana)*, 68 T.C. 325 (1977) ("the *Amoco* case"), *aff'd sub nom., Sun & Co. & Subsidiaries (Consol.)* v. *Commissioner*, 677 F.2d 294 (3d Cir. 1982), the oil companies prevailed and the appeal was dismissed. The Service has brought and lost at least two other cases on the same issue. Notwithstanding the dismissal of the appeal, the Service continued to disallow Delineation Well expenses on audit. However, as a result of a change in the tax law, the issue is no longer "is it deductible at all", but only "when" is it deductible.

Management had to decide how the company's tax liability is affected by *Amoco*, as well as the Service's continued challenge notwithstanding the Tax Court decision. Similarly management had to decide whether to accrue an amount for the potential tax liability and, if so, how much. Next the auditor had to review that accrual to see if management's evaluation is reasonable, and if not, whether the differences are material. Even if the auditor were to disagree with management's assessment of its tax position, this disagreement would not impact the tax returns in any way but would only affect the audit opinion on the taxpayer's financial statements if the disagreement related to a material amount.

The tax accrual workpapers will reflect the auditor's thought process and management's views as to whether it will stand and fight or, if it

"roadmap" of the issues which the taxpayer believes are sensitive and of the taxpayer's assessment of the strengths and weaknesses of its positions on, and settlement prospects with respect to, those issues. The taxpayer, confronted with being challenged on every point, would be forced to compromise otherwise valid positions because of the risk and expense of litigation, or else engage in protracted litigation to vindicate its rights. *United States* v. *Arthur Young & Co.*, 677 F.2d 211, 220 (2d Cir. 1981), *cert. granted*, U.S. , 103 S.Ct. 1180 (1983).

To permit one side to have that sort of "inside" information concerning the settlement posture and litigation strategies creates unequal bargaining power. Thus, the availability of such information from the auditor in a neat, compact form for the Service to pluck at its choosing creates undue tension between the audited entity and its auditor. Indeed, this tension has caused clients to be more guarded in their discussions with their auditors, and it has caused counsel representing taxpayers in litigation with the Service to be less willing to discuss the proceedings. This is not idle speculation, but a reality which Arthur Young and other major accounting firms have experienced in their practice. In fact, IRS Commissioner Roscoe Egger has conceded this. Internal Revenue News Release, IR-81-49, *reprinted in Daily Report for Executives (BNA)*, DTR NO. 86, at J-1 (May 5, 1981) (access to the auditor's tax accrual workpapers has "real potential for serious negative effects on the quality of financial reporting.")

SUMMARY OF ARGUMENT

This Court recently reaffirmed its longstanding commitment to limiting Government investigations and discovery "for sound reasons—ranging from *fundamental fairness* to concern about burdensomeness and intrusiveness." *United States v. Sells Engineering, Inc.*, U.S. , 103 S. Ct. 3133, 3143 (June 30, 1983) (emphasis added). By seeking access to

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chooses to compromise, in what amount. Obviously, if the Service knows management's position, it gives the Service a superior bargaining position on issues it has *thrice lost* in court. The inherent unfairness of this is self-evident.

tax accrual workpapers containing the thought processes of the taxpayer, its auditors, and its counsel, and thus creating an unfair advantage in an adversary process, the Government affronts the concept of fundamental fairness. The "administrative convenience" of the Service cannot justify such a result.

Courts and legislative bodies insure that litigation is fairly conducted by protecting or insulating certain types of information from disclosure through, *inter alia*:

- the balancing of competing and legitimate societal interests when they are in conflict;
- the creation of privileges or doctrines limiting access to information; and
- standards of relevancy and materiality.

The Second Circuit combined the first two of these approaches. It found that protecting tax accrual workpapers from disclosure would serve the interests of the investing public without weakening the enforcement of the revenue laws, and it effected that protection by creating a limited and qualified work product doctrine for auditors. With respect to the third of these approaches, however, the Second Circuit held, we believe incorrectly and contrary to both the facts in this case and the law, that the tax accrual workpapers are relevant.

Arthur Young respectfully submits that each of the foregoing bases provides a separate, independent ground for this Court to affirm the decision of the Second Circuit.

ARGUMENT

ACCESS TO AN AUDITOR'S TAX ACCRUAL FILES BY THE INTERNAL REVENUE SERVICE, ABSENT THE MOST COMPELLING OF CIRCUMSTANCES, RUNS COUNTER TO PRINCIPLES OF FUNDAMENTAL FAIRNESS AND WILL ERODE IMPORTANT PROFESSIONAL RELATIONSHIPS WHOSE PRESERVATION IS CRITICALLY IMPORTANT

Critical to the Second Circuit's opinion denying IRS access to the tax accrual workpapers was the concern that such access, absent the most compelling need, would run counter to the very concept of fundamental fairness and put the taxpayer at an unfair disadvantage in dealing with the Service. As that court noted:

> We do not agree with the dissent's statement that in the end, the corporation "pay[s] only what the tax laws required it to pay in the first place." This would be true if every difference of opinion were litigated. But the fact is that very few controversies reach that stage. In reality, at the end of an audit, the IRS and the taxpayers frequently compromise out their differences, each giving a little. Such negotiations strike an appropriate balance between collecting revenue and conserving judicial resources, but requiring the taxpayer alone to disclose settlement positions would improperly weight the balance.
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> • • •
>
> Divulging this information necessarily puts the taxpayer-corporation at a substantial disadvantage when it is audited. The prejudice involved in exposing to the Service appraisal of a taxpayer's weaknesses and settlement positions on audit is of such proportions that a prudent organization might not be perfectly candid with independent auditors once it knew that the information revealed would be reachable under § 7602.

677 F.2d at 220 (footnote omitted).

The court recognized that the burden imposed on the taxpayer was so great that, were it to allow such access to the IRS under these facts, other societal interests would be threatened.

On numerous occasions this Court has focused on considerations of fundamental fairness as it weighed competing interests to determine whether disclosure would be ordered. Most recently, in *United States* v. *Sells Engineering, Inc.*, U.S. , 103 S. Ct. 3133, 3143 (June 30, 1983), this Court recognized that "limitations imposed on investigation and discovery exist for sound reasons — ranging from fundamental fairness to concern about burdensomeness and intrusiveness." *See also United States v. Baggot*, U.S. , 103 S. Ct. 3164, 3167 n.4 (June 30, 1983) ("particularized need test is a criterion of *degree*"; it requires that the materials sought be "'needed to avoid a possible injustice in another judicial proceeding'.") (emphasis in original). In the context of access to grand jury testimony, this reflected "a judgment that not every beneficial purpose, or even every valid governmental purpose, is an appropriate reason for breaching grand jury secrecy." *Id.* at 3167. Similarly, this Court has held that "it is rarely justifiable for the [government] to have exclusive access to a storehouse of relevant fact." *Dennis v. United States*, 384 U.S. 855, 873 (1966) (footnote omitted).

This Court has repeatedly rejected protestations of administrative convenience, savings of time and expense, or other "shortcuts" if their effect results in inequity in the litigation process or unduly prejudices other societal interests. Thus, in *Sells* this Court noted that the "civil lawyer's need is ordinarily nothing more than a matter of saving time and expense. The same argument could be made for access on behalf of any lawyer in another government agency, or indeed, in private practice. We have consistently rejected the argument that such savings can justify a breach of grand jury secrecy." 103 S. Ct. at 3142.

This concern for fundamental fairness is the touchstone of numerous other decisions involving the relationship of the government and its citizens. *See, e.g., Federal Open Market Committee*

v. *Merrill*, 443 U.S. 340, 359-60 (1979) (unfair to place party at a competitive disadvantage in contract negotiations); *Marshall* v. *Barlow's, Inc.*, 436 U.S. 307, 322 (1978) ("Nor do we agree that the incremental protections afforded the employer's privacy by a warrant are so marginal that they fail to justify the administrative burdens that may be entailed."); *Schneider* v. *Rusk*, 377 U.S. 163, 167 (1964) (administrative convenience will not justify violation of due process); *Commissioner* v. *Lester*, 366 U.S. 299, 306 (1961) (Douglas, J., concurring) ("The revenue laws have become so complicated and intricate that I think the Government in moving against the citizen should also turn square corners."); *United States* v. *Bryan*, 339 U.S. 323, 331 (1950) (exemption from discovery where substantial individual interest outweighs public interest in search for truth); *International Shoe Co.* v. *Washington*, 326 U.S. 310, 316 (1945) (sufficient minimum contacts with forum so that "maintenance of the suit does not offend 'traditional notions of fair play and substantial justice'."); *Bowsher* v. *Merck & Co.*, U.S. , 103 S. Ct. 1587, 1594, 1599 (April 19, 1983) ("must balance the public interest served by full GAO investigations against the private interest in freedom from officious governmental intermeddling in the contractor's private business affairs"). *See also Stevens* v. *Marks*, 383 U.S. 234, 247 (1966) (Harlan, J., concurring in part and dissenting in part) (In exacting waiver of the privilege of immunity the state should turn square corners.); *United States* v. *Seckinger*, 397 U.S. 203, 221-22 (1970) (Stewart, J., dissenting).[8]

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8. An analog also exists in this Court's Fourth Amendment decisions:

> The essential purpose of the proscriptions in the Fourth Amendment is to impose a standard of "'reasonableness" upon the exercise of discretion by government officials . . . in order "to safeguard the privacy and security of individuals against arbitrary invasions . . . ." *Marshall* v. *Barlow's, Inc.*, 436 U.S. 307, 312 (1978), quoting *Camara* v. *Municipal Court*, 387 U.S. 523, 528 (1967). Thus, the permissibility of a particular law enforcement practice is judged by balancing its intrusion on the individual's Fourth Amendment interests against its promotion of legitimate governmental interests. Implemented in this manner, the reasonableness standard usually requires, at a minimum, that

Most recently this Court denied access under the F.O.I.A. to work product materials even though the litigation was long since terminated. Although the decision is written in the language of statutory construction, it is equally clear that a critical concern was the very same concept of fundamental fairness which led to the creation of the work product doctrine in the first instance. *F.T.C.* v. *Grolier Inc.*, _____ U.S. _____, 103 S. Ct. 2209, 2216 (June 6, 1983) (Brennan, J., concurring in part).

Thus the concept of "fundamental fairness" has its roots in many different judicial and statutory policy considerations. Articulation of the fundamental fairness concept within traditional legal theories can be found in creating privileges from discovery, defining relevancy and materiality, and the balancing of competing legitimate interests — each of which provides the basis for affirming the decision of the Second Circuit.

Allowing IRS access to the independent auditor's tax accrual workpapers would destroy the balance between government and taxpayer in an adversarial setting without promoting any countervailing interest.[9] Moreover, it would prejudice the important

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the facts upon which an intrusion is based be capable of measurement against "an objective standard," whether this be probable cause or a less stringent test. In those situations in which the balance of interests precludes insistence upon "some quantum of individualized suspicion," other safeguards are generally relied upon to assure that the individual's reasonable expectation of privacy is not "subject to the discretion of the official in the field" [citations omitted].

Delaware v. *Prouse*, 440 U.S. 648, 653-55 (1979) (footnotes omitted).

9. Arthur Young recognizes, as did the Second Circuit, 677 F.2d at 221, that there may be instances where a sufficient showing of need can be made to justify access to the tax accrual file. As here, where the tax accrual files contain primarily opinions and any factual data in them is otherwise available, no such showing has or can be made.

The Service's claim that the decision below threatens to impede its investigations (Pet. Br. at 14) is totally unsupported by the record, which, in fact, demonstrates the contrary. The Service repeatedly protests that its principal interest is to discover the relevant facts (*id.* at 27) to enable it to make its own appraisals (*id.* at 10). Yet the record demonstrates that the Service has all the relevant facts and that there is no "fact" in the tax accrual workpapers which is not otherwise available. (JA 38). What it really seeks is not the "raw" data, but to have that data

professional relationships between the auditor and its client. It is for this reason that AY has opposed enforcement of this summons and considers the issue of great importance.[10]

I.

SUBSTANTIAL COMPETING POLICY INTERESTS REQUIRE THE DENIAL OF IRS ACCESS TO TAX ACCRUAL WORKPAPERS ABSENT EXTRAORDINARY AND COMPELLING CIRCUMSTANCES

This Court has repeatedly recognized that Congress has not given the IRS *carte blanche* to summon anything it wants. Its power is circumscribed by statute with the burden of proof falling on the Service to show that it is entitled to summons enforcement.

"organized" for it so it has the taxpayer's and accountant's judgments "about which facts are *relevant* to the . . . tax liability." (Pet. Br. at 25-26).

10. Although Amerada's objection pursuant to 25 U.S.C. § 7609 precluded Arthur Young from compliance with the summons absent a court order, such an objection does not require the third-party recordkeeper to appear and oppose enforcement of the summons. Section 7609 merely provides a procedural mechanism for the taxpayer to intervene to protect its interests.

The district court found that Arthur Young refused to comply with the summons as a matter of its own independent judgment, and not because Amerada exercised its rights under § 7609. *United States* v. *Arthur Young & Co.*, 496 F. Supp. 1152, 1154 (S.D.N.Y. 1980), *aff'd in part and rev'd in part*, 677 F.2d 211 (2d Cir. 1982), *cert. granted*, _____ U.S. _____, 103 S.Ct. 1180 (1983). Arthur Young refused to comply with the summons because it contravened policies that Congress has clearly articulated, it was counterproductive, and it would have long term adverse consequences for the public. (JA 23 ¶ 5-6).

The seriousness and importance with which Arthur Young views this issue is underscored by the fact that William A. Grant, then the managing partner of Arthur Young's Tulsa office, was held in contempt of court and spent time in jail for refusing to produce Arthur Young's tax accrual workpapers on Phillips Petroleum to a grand jury in order to test the legality of the court's order requiring their production. *Arthur Young Faces Test on Protecting Client Audit Secrets*, Wall St. J., October 14, 1975, at 23. The matter was resolved with entry of a protective order *prohibiting* IRS access to the tax accrual file while granting access to that file to the grand jury. *Arthur Young & Company Gives Grand Jury Data on Phillips Petroleum*, Wall St. J., October 15, 1975 at 28. The same result is now dictated by *United States* v. *Sells Engineering, Inc.*, _____ U.S. _____, 103 S. Ct. 3133 (June 30, 1983).

United States v. *LaSalle National Bank*, 437 U.S. 298 (1978); *United States* v. *Powell*, 379 U.S. 48 (1964). Although *Powell* established a four-part test as a predicate to enforcement of an IRS summons, that test is a statement of general principle and is not exhaustive of the criteria that should be considered in enforcing a summons. *See Upjohn Co.* v. *United States*, 449 U.S. 383 (1981); *United States* v. *Bisceglia*, 420 U.S. 141, 146 (1975); *Reisman* v. *Caplin*, 375 U.S. 440, 449 (1964); *United States* v. *Humble Oil & Refining Co.*, 488 F.2d 953, 959 (5th Cir. 1974), *vacated for further consideration*, 421 U.S. 943, *aff'd per curiam on remand*, 518 F.2d 747 (5th Cir. 1975). In *United States* v. *First National Bank*, 699 F.2d 341 (7th Cir. 1983), the court refused to enforce a summons to a bank because compliance with the summons would have put bank employees at risk under the criminal statutes of a foreign country. The court noted that "what is required is a sensitive balancing of the competing interests at stake." *Id.* at 345. In so doing, it held:

> We think it significant in weighing the hardship factor that the bank employees who would be exposed to penalty and First Chicago, which would be ordering its Greek employees to act unlawfully, *are involved only as neutral sources of information* and not as taxpayers or adverse parties n litigation.

Id. at 346 (emphasis added).

Thus, in determining whether to enforce a summons, the effect of enforcement on countervailing policies enumerated by Congress must be considered. *United States* v. *Euge*, 444 U.S. 707 (1980).[11]

Among the "substantial countervailing policies" that exist in the instant case is the presence of public reporting on the financial statements of companies whose securities are widely traded. Beginning with the Securities Act of 1933, Congress created a system of disclosure for corporations having publicly traded

11. Accordingly, to the extent that the Service argues that § 7602 "*unequivocally* authorizes agents" of the IRS "to summon and inspect records that may be relevant to their investigation" (Pet. Br. at 12), this Court has already rejected such unfettered access.

securities. 15 U.S.C. §§ 77a *et seq*. One of the linchpins of that system is audited financial statements. *See, e.g.*, 15 U.S.C. §§ 77g, 77j, 78m. By these statutes, Congress determined to afford safeguards to investors by requiring that companies whose stock is sold to and by the public provide audited financial statements based on full and frank disclosure. If enforcement of an IRS summons will cause conflict with or undercut the policies embodied in other federal statutes, then the needs of both statutes must be reconciled.

The Service advances two arguments why this Court should ignore the countervailing policy considerations. *First*, according to the Service it is not for this Court, but rather for Congress, to decide which of the policies shall be enforced.[12] Careful analysis of this position, however, reveals that what the Service in fact argues is not that it is for Congress to make the decision between these conflicting policies, but rather that this Court should make the decision on behalf of the revenue laws and not the securities laws.[13] Whichever way this Court decides this issue, it is in fact making a policy decision between the two conflicting interests.

Second, the Service argues that there is no evidence in the record (a) that any conflict exists between the securities laws and the revenue code or (b) that IRS access to tax accrual workpapers creates problems in the relationship of the independent auditor and its client. To the contrary, the only evidence in the record below, which was based on firsthand experience, demonstrates the opposite to be the case. (JA 32 ¶ 27). Importantly,

12. In any event, Congress, in enacting the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), Pub. L. No. 97-248, following the decision of the Second Circuit in this case, chose not to override the decision denying IRS access to Arthur Young's tax accrual workpapers. In fact, the legislative history of TEFRA supports the contrary conclusion: "[T]he Committee intends that the Secretary shall in no event require disclosure of accountant's workpapers." S. REP. NO. 97-494, 97th CONG., 2d SESS. 273, 274 (1982), *reprinted in* 1982 U. S. CODE CONG & AD. NEWS 781,1021.

13. It is ironic for the Government to denigrate the importance of the securities laws as it has done in its brief. (*See, e.g.*, Pet. Br. at 42-43- "[S]ecurities regulations relate *to nothing more than* the duty of listed corporations to file annual audited statements, and the duty of auditors to examine the statements . . ." (emphasis added)).

IRS commissioner Roscoe L. Egger publicly conceded that IRS access to tax accrual workpapers had in fact created real potential for "serious negative effects on the quality of financial reporting." Internal Revenue News Release, IR-81-49, *reprinted in Daily Report For Executives (BNA)*, DTR No. 86, at J-1 (May 5, 1981). Moreover, the public record demonstrates that there has been a substantial impairment of the independent audit process. *See, e.g.*, Rout, *Auditors Say IRS Demand For Documents is Poisoning Relations with Client Firms*, Wall St. J., January 15, 1981, at 25, cols. 4-6.

If this Court allows access to tax accrual workpapers as the Service has requested, its victory will be pyrrhic. There is little doubt that several things will flow from such unfettered access. *First*, management will substantially curtail the flow of information generated in the audit process. *Second*, counsel, who already are reluctant to communicate with auditors for fear of opening their communications to discovery, will become even more reticent. *Third*, to the extent the auditor does get information from these sources or ferrets it out without the aid of management and its counsel, the auditors may be reluctant to document fully these thought processes for fear of discovery.[14] Fishman, *Intentional*

14. The non-discovery of materials relating to the deliberative process has significant societal implications. Congress has recognized the importance of insulating the decisional process from discovery when it balanced the need to know with the need to protect the deliberative process in the Freedom Of Information Act, 5 U.S.C. § 552 (1976). The courts have reached this result in cases dealing with the thought processes of government officials and, although these cases implement a specific statutory policy, their reasoning and policy considerations are equally applicable to the instant case. *See, e.g., ISI Corp. v. United States*, 503 F.2d 558, 559 (9th Cir. 1974) (per curiam) ("The opinions, conclusions and reasonings of government officials are not subject to discovery.").

> Exemption 5 to the Freedom of Information Act:
> incorporates the governmental privilege, developed in discovery cases, to protect documents containing advisory opinions and recommendations or reflecting deliberations comprising the process by which government policy is formulated.
>
> Congress adopted exemption five in recognition of the merits of arguments from the executive branch that the quality of administrative decision-making would be seriously undermined if agencies were forced to "operate in a fishbowl" because the full

Destruction of Tax Workpapers: An Analysis of a Relatively Uncharted Area, 58 J. TAX'N 214 (Apr. 1983). Although we concur with the dissent in the Second Circuit that corporate America will not knowingly violate the federal securities laws, we nevertheless believe that the risk of error will be materially increased by allowing IRS access to the auditor's workpapers for the foregoing reasons. The "bottom line" is that the audit itself will suffer and the Service will have failed to uncover the thought processes it now seeks.

In light of the countervailing policy considerations in this case, this Court can and should place limitations on the scope of demands for discovery (whether they be under IRS summons or otherwise) to effect the appropriate balance between the needs of the IRS and those of auditors, their client, and the investing public. On this ground alone, the Service should be denied access to the tax accrual workpapers.

II.

AN AUDITOR'S WORK PRODUCT DOCTRINE FOR TAX ACCRUAL WORKPAPERS WAS PROPERLY CREATED BY THE SECOND CIRCUIT

Whether it be called a privilege or a "work product" doctrine, the method by which the Court of Appeals protected the tax accrual workpapers in this case from scrutiny by the IRS was clearly an appropriate exercise of judicial power. Courts have

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> and frank exchange of ideas on legal or policy matters would be impossible. A decision that certain information falls within exemption five should therefore rest fundamentally on the conclusion that, unless protected from public disclosure, information of that type would not flow freely within the agency.

Mead Data Central, Inc. v. United States, 566 F.2d 242, 256 (D.C. Cir. 1977) (footnotes omitted).

This Court approved the "factual-deliberative" distinction in the legislative history of Exemption 5 in *EPA v. Mink*, 410 U.S. 73, 89, 91 (1973). *See also N.L.R.B. v. Robbins Tire & Rubber Co.*, 437 U.S. 214, 241 (1978) ("The possibility that a FOIA-induced change in the Board's prehearing discovery rules will have a chilling effect on the Board's sources cannot be ignored."); *N.L.R.B. v. Sears, Roebuck & Co.*, 421 U.S. 132 (1975).

historically created privileges or doctrines to meet the exigencies of a situation and to insure that fundamental fairness is protected by the judiciary. There is historical precedent for the result reached by the Second Circuit. *See, e.g., Hickman v. Taylor*, 153 F.2d 212 (3d Cir. 1945), *aff'd*, 329 U.S. 495 (1947).

With the adoption of the Federal Rules of Evidence in 1974, any question regarding the ability of a court to create a privilege/doctrine in the circumstances here was laid to rest. Rule 501 of the Federal Rules of Evidence provides that "the privilege of a witness . . . shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience." The Senate Committee on the Judiciary, which steered the Federal Rules through Congress, stated that "a federally developed common law based on modern reason and experience shall apply." Notes of the Committee on the Judiciary, S. REP. NO. 93-1277, 93d CONG., 2d SESS. 11 (1974), *reprinted in* 1974 U.S. CODE CONG. & AD. NEWS 7051, 7058. As this Court noted in *Trammel v. United States*, 445 U.S. 40, 47 (1980): "Congress manifested an affirmative intention not to freeze the law of privilege. Its purpose rather was to 'provide the courts with the flexibility to develop rules of privilege on a case-by-case basis,' 120 CONG. REC. 40891 (1974) (statement of Rep. Hungate), and to leave the door open to change." *Accord Upjohn Co. v. United States*, 449 U.S. 383, 396 (1981).

In fact, the "Federal Rules of Evidence acknowledge the authority of the federal courts to continue the evolutionary development of testimonial privileges in federal criminal trials 'governed by the principles of the common law as they may be interpreted . . . in the light of reason and experience'." *Trammel v. United States*, 445 U.S. 40, 47 (1980) (*quoting* FED. R. EVID. 501). Congressional enactment of Rule 501 thus "provide[s] the courts with greater flexibility in developing rules of privilege on a case-by-case basis." *United States v. Gillock*, 445 U.S. 360, 367 (1980).

Thus, courts have fashioned privileges from discovery where appropriate, and this willingness to shape the law of privilege to

meet developing needs even extends to the most sacrosanct forum for discovery, the grand jury. In *In re Subpoena Served upon Jorge S. Zuniga, M.D.*, _____ F.2d. _____, Nos. 82-1906, 82-1907, 82-1964 (6th Cir. August 3, 1983), the court held that in appropriate circumstances a patient-psychiatrist privilege will preclude enforcement of a grand jury subpoena. Similarly, a new qualified "academic freedom privilege" protecting the names of and identities of academicians participating in tenure evaluations from an EEOC investigation was created in *E.E.O.C. v. University of Notre Dame DuLac*, No. 82(c) 104 (7th Cir. August 17, 1983). Thus, the courts have been willing to create new "privileges" under Rule 501 even when there is an adverse government interest.

Here, applying the teachings of both Rule 501 and this court's admonition in *Trammel*, the Second Circuit continued "the evolutionary development of testimonial privilege . . . in the light of reason and experience." 445 U.S. at 48.It weighed the various competing factors and determined that the tax accrual workpapers, under the facts here present, should be insulated from unfettered IRS access. It carefully crafted the protection so that there could be access on "a sufficient showing of need." 677 F.2d at 221. Thus, to the extent that the Service avers that there is no basis for creation of the privilege, its arguments run contrary to well-established law.

Couch v. United States, 409 U.S. 322 (1973), which the Service frequently cites (Pet. Br. at 5, 9, 11, 14, 28, 32, 35, 36, 38), does not compel a different result. First, *Couch* involved a bookkeeper who was not even a CPA, not a firm of certified public accountants auditing the financial statements of a public company. Second, even more significantly, the information sought in *Couch*, unlike in this case, was the taxpayer's records which were in possession of the bookkeeper. Here the issue is the auditor's work product which contains its thoughts and impressions, not the transactional records created by the client. The distinction was made clear in *Donaldson v. United States*, 400 U.S. 517, 530 (1971):

> We turn, then, to Donaldson's particular situation. The material sought, as has been noted, consists only of Acme's routine business records in which the taxpayer has no proprietary interest of any kind, *which are not the work product of his* attorney or *accountant*, and which enjoy no established attorney-client or other privilege.

(emphasis added).

Finally, even if *Couch* controls the question of whether there can be an accountant-client privilege in the federal courts comparable to the attorney-client privilege, it is not germane to the issue before the Court. At stake here is an auditor's work product doctrine. This is as different from an accountant-client privilege as the attorney's work product doctrine is from the attorney-client privilege.

The Service makes much of Judge Newman's argument in dissent below that, because the auditor's work product doctrine as explicated by the panel majority would protect some communication, it was, in fact, a testimonial privilege already precluded by *Couch*. The argument reflects a serious misunderstanding of the majority opinion below. What the doctrine protects is the thought process of the auditor in much the same way that the attorney's work product doctrine protects the thought process of counsel. In either instance, information communicated orally is protected as an incident of protecting the thought process. As this Court said in *Hickman* v. *Taylor*, 329 U.S. 495, 511 (1947): "Proper preparation of a client's case demands that [the lawyer] assemble information," and characterized this process as occurring through interviews, among other means. *See generally* 329 U.S. at 515-19 (Jackson, J., concurring). Just as the presence of a communication in *Hickman* did not transform the attorney's work product doctrine into a testimonial privilege, so also here communication between auditor and client does not render the protection testimonial.

The Service further argues that, even if it were proper to create a privilege here, the privilege would only be available if there were

a valid "expectation of privacy." The Service claims none exists[15]

15. To the extent the Service suggests that no "expectation of privacy" exists with respect to communications between a client and its auditor, the statement is unfounded. Each state, the District of Columbia, and Puerto Rico have created Boards of Accountancy to regulate the practice of public accountancy pursuant to a grant of authority by the state legislature or, in the case of the District of Columbia, by Congress. These quasi-administrative agencies have adopted rules and regulations concerning the conduct of the practice of public accountancy, the violation of which can cause loss of one's license to practice or civil liability for breach of those rules—such as a breach of a confidentiality rule. *See, e.g., Family Health Foundation* v. *Peat, Marwick, Mitchell & Co.*, 556-004 (La. Civ. Dist. Ct. - Parish of Orleans, May 10, 1974) (if auditors had made available information to U.S. attorneys outside Federal Grand Jury prior to return date of subpoena, they would be liable to client for breach of Louisiana accountant/client privilege statute). *ConsoliData Services, Inc.* v. *Alexander Grant & Co.*, (79 Civ-02-590 Court of Common Pleas, Franklin County, Ohio), *appeal pending*. (Jury verdict against Alexander Grant & Co. in the amount of $1,300,000 for alleged breach of confidentiality rules of Ohio State Board of Accountancy.) *Client's Suit Against Alexander Grant Spotlight's 'the Accountant's Dilemma'*, Wall St. J., October 27, 1981 at 8. *See also Horne* v. *Patton*, 291 Ala. 701, 287 So. 2d 824 (1973) (physician can be civilly liable for breach of confidential physician/patient relationship); *Geisberger* v. *Willuhn*, 72 Ill. App. 3d 435, 390 N.E.2d 945 (1979) (breach of confidential relationship and breach of contract are coextensive). *Cf. Valley Bank of Nevada* v. *The Superior Court of San Joaquin County*, 15 Cal. 3d 652, 547 P.2d 977, 125 Cal. Rptr. 553 (1975) (en banc).

Each State Board of Accountancy has adopted a rule of confidentiality as to materials provided by a client to its CPA. *See, e.g.*, N.Y. EDUC. LAW § 6502 (MCKINNEY) and Rules Promulgated pursuant thereto at § 70.5(a)(7). N.Y. ADMIN. CODE tit. 8, § 70.5(a)(7). The respective ethics codes of professional conduct of the AIPCA and state CPA societies impose similar responsibilities. Similarly, as a matter of policy to reflect changing societal needs, the legislatures of 17 states and Puerto Rico have codified this expectation of privacy into a formal privilege. (Appendix A contains a listing of the confidentiality regulations for each state.) *Cf. Couch* v. *United States*, 409 U.S. 322, 350-51 (1973) (Marshall, J., dissenting) ("It would be relevant to a decision about the expectation of privacy that an accountant-client privilege existed under local law. . . . But I would think that, privilege or not, a disclosure to an accountant is rather close to a disclosure to an attorney.").

Arthur Young does not argue here (nor did it do so below) that there is a statutory or common law privilege which insulates its tax accrual papers for Amerada from the IRS. Rather, Arthur Young urges that, where an expectation of confidentiality exists, as reflected in state statutory privileges or requirements of confidentiality or where there are strong public interests which could be jeopardized, such as the full

because it could call for all materials underlying the tax return. (Pet. Br. at 6, 11-12.) This is a *non sequitur*. Because a client's communication of facts to an attorney is otherwise discoverable from the client does not mean that the client has no expectation of privacy as to the communication. At no time has Arthur Young ever suggested that the facts underlying "the tax returns and payments" are not discoverable by the Service. Rather, Arthur Young recognizes that these underlying facts are discoverable and has pointed out that the Service has, in fact, obtained such data here. *See* discussion *supra* at 5, 15 n. 9. It is axiomatic that the materials underlying the return are *not* the same as opinions (created after the returns have been filed) evaluating the financial reporting impact of tax positions previously taken on prior returns. *Cf.* FED. R. EVID. 407.

Finally, to the extent that the Government devotes much of its brief to distinguishing the accountant from the attorney and noting that only the attorney-client privilege was recognized at common law, we note that the accounting profession is barely one hundred years old; and its development is really a product of the past 50 years. This is precisely the situation contemplated by both Rule 501 and this Court's opinion in *Trammel* — the development of privilege based on modern reason and experience. Such experience dictates the need to carve out the limited privilege at issue here.

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financial reporting mandated by the Federal securities law, a much greater showing of need must be made before access can be obtained. Under these circumstances the creation of a qualified privilege (or doctrine) is a proper exercise of judicial discretion. This is particularly applicable where the information is sought from a third-party and the transactional documents which control the contested issues are available from the taxpayer.

III.

THE TAX ACCRUAL WORKPAPERS ARE NOT RELEVANT OR MATERIAL WITHIN THE MEANING OF SECTION 7602

As this Court noted in *United States* v. *LaSalle National Bank*, 437 U.S. 298, 316 n.18 (1978):

> Congress has bestowed upon the Service the authority to summon production for four purposes only: for "ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax . . . or collecting any such liability."

It is only the first of these four grants of authority that is applicable here—ascertaining the correctness of Amerada's tax return. Thus, the relevancy of the materials sought must be tested by whether they will assist in ascertaining the "correctness" of a tax return.

Relevancy should not be confused with convenience. There is little doubt that the tax accrual papers would be highly convenient for the Service. They would, in fact, provide the road map to all possible tax issues, as well as an intimate understanding of the taxpayer's intentions with respect to pending disputes with the Service. But convenience is neither a substitute for, nor the *sine qua non* of, relevancy.[16] In fact, in many instances, as here, there is no relationship between the two.

To the extent that the tax accrual workpapers contain facts, those facts are otherwise available from the taxpayer, in the public record, or in other audit workpapers which are otherwise available to the Service. This is indisputable. (JA 38). The bulk of the tax accrual workpapers, however, contain material which is not factually oriented, but is instead analytic, impressionistic, and

16. *See, e.g., United States* v. *Arthur Young & Co.*, 496 F. Supp. 1152, 1157 (S.D.N.Y. 1980), *aff'd in part and rev'd in part*, 677 F.2d 211 (2d Cir. 1982), *cert. granted*, U.S. , 103 S.Ct. 1180 (1983) (convenience is not the touchstone; access to audit plans and programs denied); *United States* v. *Davey*, 543 F.2d 996, 1000 (2d Cir. 1976); *United States* v. *Matras*, 487 F.2d 1271, 1275 (8th Cir. 1973).

speculative. Such material is not, and cannot be, relevant. Further, the fact that the independent auditors may have analyzed a tax return issue in a particular way long after the tax return was filed makes tax accrual workpapers inadmissible in evidence under any definition of relevancy. The tax accrual workpapers would not tend to prove the truth of the matter at issue or tend to show that the matter at issue is more probable or less probable of being true. FED. R. EVID. 401.[17]

THUS, IN *P.T. & L. Construction Co., Inc. v. Commissioner*, 63 T.C. 404 (1974), the Service opposed discovery of an IRS Special Agent's report and the Appellate Conferee's report on a disputed tax matter. The court denied access on the grounds that the material was irrelevant:

> What is relevant is the *factual information* which may either reveal evidence that will be admissible at the trial or lead to the discovery of such evidence. Mental impressions, legal analysis, conclusions, and recommendations are generally not relevant.

Id. at 414.

See also United States v. El Paso Co., 682 F.2d 530, 545-51 (5th Cir. 1982) (Garwood, J., dissenting) (only factual data is relevant), *petition for cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716).

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17. In *United States v. Allison*, 474 F.2d 286, 289 (5th Cir. 1973), the court held:

> [R]elevancy describes the logical relationship between a proffered item of evidence and a proposition that is material or provable in a given case. *See* . . . C. McCormick, *supra*, § 152 ("the tendency of the evidence to establish a material proposition"); 1 F. Wharton, *supra*, § 148; 1 Wigmore, *supra*, § 12. According to Rule 401, Rules of Evidence . . . relevant evidence means "evidence having any tendency to make the existence of any fact that is of consequence to the determination of the action more probable or less probable than it would be without the evidence." Thus, evidence is relevant when it is persuasive or indicative that a fact in controversy did or did not exist because the conclusion in question may be logically inferred from that evidence. *Cf. Butler v. Watkins*, 80 U.S. (13 Wall.) 456, 20 L.Ed. 629 (1871).

Accord Williams v. Hoyt, 556 F.2d 1336, 1339 (5th Cir. 1977), *cert. den.*, 435 U.S. 946 (1978).

The court also denied production of those portions of the Special Agent's report which contained "a statement of the recommendation of the revenue agent, and the recommendations of the Special Agent and his deliberations that lead him to his recommendations. No new fact is recited in these portions of the report." *Id.* The court went on to reject discovery of the Appellate Conferee's report because it contained:

> summary of the facts already in the file, his analysis of the law as applied to those facts, and his recommendation on any settlement proposal discussed at the conference. The report does not contain any new *factual* information. . . . In our judgement the objectives of discovery do not require the production of this material. Its only value to petitioners lies in its statement of the legal theory adopted by the conferee."

Id. at 411-12.

Similarly, in *Esson v. Commissioner*, 34 Tax Ct. Mem. Dec. 586 (CCH) (1975), the tax court held that the petitioning taxpayer was entitled to discovery of all facts upon which the IRS valued shares of stock for gift tax purposes but denied access to judgments and opinions. The court stated:

> However, to the extent that by certain interrogatories, petitioners have sought to discover how respondent weighed the various elements of factual data in making his determinations as to value, *we think that petitioners are seeking discovery of an adverse party's mental impressions and analyses of a case, areas which are not generally open to discovery under our rules. P.T. & L. Construction Co.*, 63 T.C. at 414; note to Rule 70(b) Tax Court Rules of Practice and Procedure (60 T.C. 1098). *Cf. Hickman v. Taylor*, 329 U.S. 495 (1947). As to such interrogatories, . . . we hold that no further response from respondent is required.

Id. at 586-87 (emphasis added).

Ironically, the Service itself has conceded that opinions in the tax accrual file are not relevant. In IRS Information Notice 80-7, which announced the Manual change, 1 [Audit] INT. REV.

MAN. (CCH) § 4024, on tax accrual workpapers, the IRS stated: "The examiner's interests in the 'items' that make up the tax accrual does not include the independent accountant's or taxpayer's opinion of the value of issues or the likelihood of success in litigation . . ." Notwithstanding this concession, the Service is pursuing those opinions. (Pet. Br. at 25-26.)

The court's decision in *P.T. & L.* was a product of balancing "the interest of taxpayer discovery against government privacy . . . ." 63 T.C. at 411. Historically, the determination of relevancy has been a product of the balancing of interests. As one commentator has noted:

> A careful analysis of these cases reveals that the courts have applied the relevancy and convenience tests only after they had already decided the greater underlying interests involved. Arguably, any document that sheds light upon a tax return would be convenient to the IRS. Alternatively, any information that makes the Service's investigation more convenient would shed light upon the return because the very nature of the Service's inquiry is focused to this end. The two courts that have denied access on relevancy grounds nevertheless concluded that the papers were convenient. Thus, if these courts had applied the liberal "might have thrown light upon the return" test, the result might have been different.
>
> The above analysis lends credibility to the premise that the relevancy concept inherently involves a balancing process.[148]

148 *See* C. MCCORMICK, HANDBOOK OF THE LAW OF EVIDENCE § 77, at 159-60 (E. Cleary 2d ed. 1972):

> Reconciling interests in privacy and confidentiality with the needs of litigants is not readily achieved in terms of broad categories; it calls for the finer touch of the specific solution. A tool already at hand, though perhaps largely unrecognized, consists of recognizing standing on the part of the possessor of information to question the legitimacy of need for it in litigation, *i.e.*, to raise issues of relevancy in the broad sense . . . Relevancy

> itself, of course, contemplates a process of weighing, and inevitably the judge must be accorded a substantial measure of discretion.

Note, *Auditor-Client Work-Product Privilege With Respect To Tax Accrual File: The Arthur Young Case*, 27 ST. LOUIS U.L.J. 437, 453-54 (1983)(footnote omitted.)

Thus even when facts are sprinkled through the evaluative materials, the courts have found the material sought was not relevant, if the facts are otherwise available. *Esson v. Commissioner*, *supra*, and *P.T. & L. Construction Co., Inc. v. Commissioner*, *supra*. Specifically with respect to the tax accrual files, both courts which considered the issue in *United States v. Coopers & Lybrand*, 413 F. Supp. 942 (D. Colo. 1975), *aff'd*, 550 F.2d 615 (10th Cir. 1977), found the tax accrual workpapers were not relevant.

In *Union Carbide Corp. v. Travelers Indemnity Co.*, 61 F.R.D. 411 (W.D. Pa. 1973), a closely analogous case, an insurance company was asked in discovery what reserves it carried on the liability asserted in the case. "The answers sought involve[d] the internal opinions and conclusions of [the insurer]." *Id.* at 413. Noting that the 1970 amendments to the Federal Rules rendered opinions discoverable, the court nevertheless held:

> [T]he intent of the Rules is directed to opinions as to factual issues in controversy and do not render discoverable the internal opinions and conclusions [the insurer] has reached in valuating the reserves in issue. We note that Travelers has not cited and we have not discovered any authority for compelling the discovery of an insurance carrier's reserve against the liability asserted either in the principal case or in collateral claims. More importantly, we do not believe that the proper end of discovery—expedition of the litigation either by narrowing the areas of controversy or by avoiding unnecessary testimony or by providing a lead to evidence—will be served by allowing discovery of the reserves in question.

Id. (citations omitted).

Not only has no general relevancy been shown here for the tax accrual papers, but also when the record is examined, it is clear that the tax accrual papers can have no relevance whatsoever to the subject matter of the investigation — at least as defined by the affidavits in support of summons enforcement below. The affidavits stated only that the summoned records were needed "to ascertain the correctness of the 1972, 1973 and 1974 returns" except for one matter which was specifically identified. As to this one matter Arthur Young submitted the affidavit of Bruce Greenwald, tax partner on the Amerada audit, who stated that he reviewed "the tax accrual workpapers prepared by Arthur Young in connection with its audits of Amerada for the years 1972, 1973 and 1974 [and] there is no information whatever" therein with respect to that matter. (JA 38 ¶¶2, 3). Under these facts, especially when applying the balancing test, it is clear that the tax accrual workpapers are neither relevant nor material.

CONCLUSION

IRS access to the thought processes and evaluations of the independent auditors runs afoul of inherent fundamental fairness, particularly where the Service is in an adversarial posture with the taxpayer as to matters contained therein. Such access would seriously damage important professional relationships and other critically important Congressionally mandated policies. Absent a compelling specific need, which has not been shown here, the Service should not be allowed access to these documents. Accordingly, the opinion of the Court of Appeals should be affirmed.

DATED: September 9, 1983
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APPENDIX A

State Board of Accountancy Confidentiality Regulations

State	Enabling Statute	Confidentiality Regulations*
Alabama	Ala. Code § 34-1-3(n) (1975)	Reg. 5, 4(1) CCH ALR ¶1254
Alaska	Alaska Stat. § 08-04-080	12 AAC 04.020 Authority: AS 08.04.070(b); AS 080.04.080 CCH ALR ¶ 1604
Arizona	Ariz. Rev. Stat. Ann. § 703 (A)(1) (Supp. 1981-82)	Rule C(1) CCH ALR ¶ 2403
Arkansas	Ark. Stat. Ann. § 71-612(d) (1979)	Arkansas has adopted with minor changes the code of professional conduct of the National Association of State Boards of Accountancy CCH ALR ¶ 3271
California	Cal. Bus. & Prof. Code § 5018 (West Supp. 1982)	Rule 54 CCH ALR ¶ 4402
Colorado	Colo. Rev. Stat. § 12-2-104-(2)(c) (1973)	Colorado has adopted with minor changes the code of professional conduct of the National Association of State Boards of Accountancy CCH ALR ¶ 5401
Connecticut	Conn. Gen. Stat. Ann. § 20-280 (Supp. 1982)	Sec. 20-280-15C CCH ALR ¶ 6401
Delaware	Del. Code Ann. tit. 24, § 109(9) (1974)	Delaware has adopted the code of professional ethics of the American Institute of Certified Public Accountants CCH ALR ¶ 7301
Dist. of Columbia	D.C. Code Ann. § 2-103(i)(2)	CH. II. Sec. 202 CCH ALR ¶ 8153
Florida	Fla. Stat. Ann. § 473.304 (1981)	Rule 21A-23.01 CCH ALR ¶ 9238

* The confidentiality rule promulgated by each Board of Accountancy is listed. Each rule can be found in CCH Accountancy Law Reporter (hereafter cited "CCH ALR").

State	Enabling Statute	Confidentiality Regulations*
Georgia	Ga. Code. Ann. § 43-3-5(a)(2) (Supp. 1982)	Georgia has adopted with minor changes the code of professional conduct of the National Association of State Boards of Accountancy CCH ALR ¶ 10,401
Hawaii	Hawaii Rev. Stat. § 466-4(f)(2) (1976)	Hawaii has adopted the code of professional conduct of the National Association of State Boards of Accountancy except subrule (c), Rule 404 and entire Rule 405 CCH ALR ¶ 10,801
Idaho	Idaho Code § 54-204-A.(1)	Rule 301 CCH ALR ¶ 11,405
Illinois	Ill. Rev. Stat. Ch. 111 § 5532 (1969)	Rule 301 CCH ALR ¶ 12,406
Indiana	Ind. Code Ann. § 25-2-1-3(L) (Burns 1982)	Indiana has adopted the code of professional conduct of the National Association of State Boards of Accountancy CCH ALR ¶ 13,301
Iowa	Iowa Code Ann. § 116.3-4(a-i) (West Supp. 1982-1983)	Rule 10-11.6(116)(i) CCH ALR ¶ 14,481
Kansas	Kan. Stat. Ann. § 1-203-(C)(1) (1982)	Kansas has adopted with some changes the code of professional conduct of the National Association of State Boards of Accountancy CCH ALR ¶ 15,351
Kentucky	Ky. Rev. Stat. § 325.240 (1977)	Rule 301 CCH ALR ¶ 16,405
Louisiana	La. Rev. Stat. Ann. § 37:75-B(2) (West Supp. 1982)	Louisiana has adopted with changes the code of professional conduct of the National Association of State Boards of Accountancy CCH ALR ¶ 17,301
Maine	Me. Rev. Stat. Ann. tit. 32, § 3972 (Supp. 1982)	Maine has adopted with some changes the code of professional conduct of the National Assocation of State Boards of Accountancy CCH ALR ¶ 18,401

State	Enabling Statute	Confidentiality Regulations*
Maryland	Md. Ann. Code of 1957 § 75A(1)(d) (1957)	Maryland has adopted with minor changes the code of professional conduct of the National Association of State Boards of Accountancy CCH ALR ¶ 19,301
Massachusetts	Mass. Gen. Laws Ann. ch. 112 § 87-C(a) (1971)	Sec. 3.03(1) CCH ALR ¶ 23,504
Michigan	Mich. Stat. Ann. § 339.308 (West Supp. 1982)	Sec. 338.2120 (Confidential information) CCH ALR ¶ 24,514
Minnesota	Minn. Stat. Ann § 326.18 (1981)	Minnesota has adopted the restatement of the code of professional ethics of the American Institute of Certified Public Accountants with minor modifications CCH ALR ¶ 25,721
Mississippi	Miss. Code Ann. § 73-33-5 (Supp. 1982)	Rule 301 CCH ALR ¶ 26,615
Missouri	Mo. Ann. Stat. § 326.160.1 (Vernon Supp. 1983)	Missouri has adopted the code of professional conduct of the National Association of State Boards of Accountancy with minor changes CCH ALR ¶ 27,501
Montana	Mont. Code Ann. § 37-50 (1981)	Rule 301 CCH ALR ¶ 28,701
Nebraska	Neb. Rev. Stat. § 1-112 (1977)	Rule 5 CCH ALR ¶ 29,505
Nevada	Nev. Rev. Stat. § 628.160 (1981)	Rule 301 CCH ALR ¶ 30,531
New Hampshire	N.H. Rev. Stat. Ann. § 309-A:2-a-I(f) (Supp. 1981)	Part Ac 505 Rule 01 CCH ALR ¶ 31,701
New Jersey	N.J. Stat. Ann. § 45:2B-6 (West 1978)	Rule 7(a) Sec. 13:29-3.4 CCH ALR ¶ 32,507
New Mexico	N.M. Stat. Ann. § 61-28-6 (Supp. 1978)	New Mexico has adopted the code of professional conduct of the National Association of State Boards of Accountancy with minor changes CCH ALR ¶ 33,501

State	Enabling Statute	Confidentiality Regulations*
New York	N.Y. Educ. Law § 7403 (McKinney's 1977)	Part 29 Sec. 70.5 CCH ALR ¶ 34,101 & ¶ 34,102
North Carolina	N.C. Gen. Stat. § 93-12(8b) (Supp. 1981)	Sec. 0204 CCH ALR ¶ 35,714
North Dakota	N.D. Cent. Code § 43-02. 1-02.-6 (1977)	North Dakota has adopted with changes the restatement of the code of professional ethics of the American Institute of Certified Public Accountants See also Sec. ¶ 84-216
Ohio	Rev. Code Ann. § 4701.03 (Page 1977)	Ohio has adopted the rules of conduct, restatement of the code of professional ethics of the American Institute of Certified Public Accountants, with some changes CCH ALR ¶ 37,501
Oklahoma	Okla. Stat. Ann tit. 59, § 15.5 (West 1971)	Art. 301 CCH ALR ¶ 38,171
Oregon	Or. Rev. Stat. § 673.445 (1981)	Rule 301 CCH ALR ¶ 39,701
Pennsylvania	63 PA. Const. Stat. Ann. § 9.3(10) (Purdon Supp.1982-83)	Sec. 11.1 CCH ALR ¶ 40,025
Puerto Rico	P.R. Laws Ann. tit. 20, § 773 (1974)	Sec. 773-204
Rhode Island	R.I. Gen. Laws § 5-3-10 (197_)	Art. 3, Sec.3.1 CCH ALR ¶ 42,321
South Carolina	S.C. Code Ann. § 40-1-140 (Law. Coop. 1976)	South Carolina has conformed to the restatement of the code of professional ethics of the American Institute of Certified Public Accountants with minor changes CCH ALR ¶ 43,501
South Dakota	S.D. Codified Laws Ann. § 36-20-1 (1977)	S.D. Admin. Code - Ch. 20:37:04:14 CCH ALR ¶ 44,514

State	Enabling Statute	Confidentiality Regulations*
Tennessee	Tenn. Code Ann. § 62-1-111 (1982)	Tennessee has adopted the restatement of the code of professional ethics of the American Institute of Certified Public Accountants without substantial changes CCH ALR ¶ 45,612 (rule 12 confidential client information deleted; but Tennessee has a privilege statute: § 62-1-116.
Texas	Tex. Rev. Civil Stat Ann. art. 41a § 4(A) (Vernon Supp. 1982-1983)	Ch. 501 Sec. 501.31 CCH ALR ¶ 46,631
Utah	Utah Code Ann. § 58-1-7 (Supp. 1981)	Utah has adopted the code of professional conduct of the National Association of State Boards of Accountancy CCH ALR ¶ 47,501
Vermont	Vt. Stat. Ann. tit. 26, § 54 (Supp. 1983)	Vermont has adopted the code of professional conduct of the National Association of State Boards of Accountancy, with certain modifications CCH ALR ¶ 48,501
Virginia	Va. Code § 54-84 (1982)	Sec. 16.01 CCH ALR ¶ 50,347
Washington	Wash. Rev. Code Ann. § 18.04.070 (1978)	Washington Admin. Code 4-16-370 Rule 301 CCH ALR ¶ 51,501
West Virginia	W.V. Code § 30-9-1 (1980)	Rule 21.03 CCH ALR ¶ 52,405
Wisconsin	Wisc. Stat. § 442.01(2) (Supp. 1982-1983)	Wisc. Admin. Code, Accountancy Reg's Subchapter III, Accy 1.301 CCH ALR ¶ 53,421
Wyoming	Wyo. Stat. § 33-3-108(a)(ii) (1977)	Rule 301 CCH ALR ¶ 54,401

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OCTOBER TERM, 1983

UNITED STATES OF AMERICA, PETITIONER

v.

ARTHUR YOUNG & COMPANY, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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In the Supreme Court of the United States

OCTOBER TERM, 1983

No. 82-687

UNITED STATES OF AMERICA, PETITIONER

v.

ARTHUR YOUNG & COMPANY, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

1. The holding of the court of appeals, that tax accrual workpapers are privileged from production pursuant to an IRS summons issued under 26 U.S.C. 7602,[1] was based on what the court saw as its "require[d]" role "to balance strong public policies against a party's need for information whenever a conflict between the two arises" (Pet. App. 28a). Respondents ask this Court to engage in the same balancing. We do not think, however, that federal courts have so broad a license to pick and choose among competing policies or to deny enforcement to government demands for information pursuant to statutory provisions enacted by Congress. Compare, *e.g.*, *United States* v. *Euge*, 444 U.S. 707, 713 (1980), quoting *United States* v. *Bryan*, 339 U.S. 323, 331 (1950) (exemption from testimonial obligations "grounded in a substantial individual interest which has been found, through centuries of experience, to outweigh the public interest in the search for truth").[2] In any event, the justifications advanced by the

[1] The decision below is contrary to the decisions of every other court that has considered the issue (see U.S. Br. 36-39) and has recently been rejected by the Eleventh Circuit. See *Matter of Newton*, 718 F.2d 1015, 1020-1021 (1983); see also *United States* v. *I.C. Industries, Inc.*, 555 F. Supp. 219, 222-223 (N.D. Ill. 1983).

[2] Respondents can be read to suggest (Arthur Young (AY) Br. 21-22; Amerada Hess (AH) Br. 21-24) that Fed. R. Evid. 501

court of appeals and renewed by respondents—the perceived unfairness of allowing IRS access to tax accrual workpapers and the asserted conflict between the federal tax and securities laws—are insufficient to warrant the judicial establishment of an accountant privilege. If such a privilege is to be created, it should be done by Congress, which is best suited to weighing the competing statutory objectives and gathering the facts necessary to reach a sound and informed decision.[3]

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affirmatively charges and encourages the courts to create new privileges. But, as the Rule explicitly provides, privileges are to "be governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience." As discussed in our opening brief (at 15, 17), the creation of privileges is not favored, and a heavy burden rests on the proponent to justify the need for the privilege. Federal law has never recognized an accountant privilege, and no such privilege was enumerated in the proposed version of the Federal Rules of Evidence or advanced in the hearings on the Rules. See 56 F.R.D. 183, 230, 233 (1973); *Proposed Rules of Evidence: Hearings Before the Special Subcomm. on Reform of the Criminal Laws of the House Comm. on the Judiciary*, 93d Cong., 1st Sess. (1973); see also 8 J. Wigmore, *Evidence* § 2286, at 536-537 (McNaughton rev. ed. 1961) (rejection of accountant privilege by Model Code of Evidence, Uniform Rules of Evidence, and American Bar Association). In substituting the current Rule 501 for the enumeration of specific privileges in the proposed Rules, Congress primarily sought to permit state evidentiary rules to govern the question of privilege in connection with state-law issues in diversity cases (see S. Rep. 93-1277, 93d Cong., 2d Sess. 6-7, 12 n.17 (1974)); although Rule 501 also provides flexibility with regard to federal privileges, Congress did not intend to override the well-established principles disfavoring the creation of new privileges. See *United States* v. *Gillock*, 445 U.S. 360, 367-368 (1980). And nowhere in the course of enacting Rule 501 did Congress indicate an intent to override the analysis in *St. Regis Paper Co.* v. *United States*, 368 U.S. 208 (1971), that a statute should not be read as creating a new privilege unless it clearly so provides (see U.S. Br. 43; page 8, *infra*).

[3] Respondents cite (AY Br. 3-4 n.3; AH Br. 16-17 & n.*, 19, 30) a number of articles in support of their position. In the main these were written by lawyers and accountants in private tax practice and therefore do not necessarily represent a neutral and detached assessment of the issue. In addition, respondents largely

a. Respondents contend (Arthur Young (AY) Br. 3, 10, 12-16; Amerada Hess (AH) Br. 6-11) that it would be "fundamentally unfair" to permit the IRS to have access to tax accrual workpapers. We submit that it is not at all unfair to allow the IRS access to these relevant materials prepared in connection with an independent audit by an independent accountant.

Respondents' claim of unfairness must be viewed "against the familiar background that our tax structure is based on a system of self-reporting. There is legal compulsion, to be sure, but basically the Government depends upon the good faith and integrity of each potential taxpayer to disclose honestly all information relevant to tax liability." *United States* v. *Bisceglia*, 420 U.S. 141, 145 (1975). Under the revenue laws, taxpayers are required to collect and reveal a great deal of information that may ultimately be to their disadvantage. While such duties "involve some invasion of privacy, they are essential to our self-reporting system" (*id.* at 146). Thus, respondents seek a privilege "in the very situation where obligations of disclosure exist and under a system largely dependent upon honest self-reporting even to survive." *Couch* v. *United States*, 409 U.S. 322, 335 (1973).

Of course, a taxpayer has no duty to maximize its tax liability. But the taxpayer's obligation is not merely to pay such amounts as the IRS is capable of enforcing. A taxpayer—unlike a litigant (compare *Hickman* v. *Taylor*, 329 U.S. 495 (1947))—is not free to play its cards close to its vest in the hope of going undetected or to turn the tax system into "a sophisticated game of hide and seek."

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ignore the authorities that go against their position. See, *e.g.*, 2 Weinstein & Berger, *Weinstein's Evidence* 146-147, 175 (Dec. 1982 Supp.); Jacobson & Steel, *The Auditor Work-Product Privilege*, 16 Review of Securities Regulation 892 (May 18, 1983); Note, *Tax Accrual Workpapers and IRS Summonses Under IRC § 7602: The Accountant Work-Product Privilege*, 48 Mo. L. Rev. 825 (1983).

United States v. *Price Waterhouse & Co.*, 515 F. Supp. 996, 1000 (N.D. Ill. 1981).[4]

Respondents' claim of privilege is also at odds with the fundamental premises underlying the regulation of publicly held corporations under the securities laws. Under the securities laws corporations like Amerada Hess are required to develop and disclose to the public and the government a full range of information bearing on the company's financial health. Cf. *Shapiro* v. *United States*, 335 U.S. 1 (1948). As discussed in our opening brief (at 3, 21, 29-33, 36-37), the principal instrument for such disclosure is the *independent* audit to be performed by the *independent* certified public accountant. That accountant owes his primary duty of loyalty not to the client but to the shareholders, the creditors, and the government—in sum, to the public. Independent public accountants are, in this context, an instrument of visitation and oversight. They do not function like lawyers, who owe undivided loyalty to the client and whose primary function is to give the client confidential advice. (Also to be distinguished is the role of the accountant when he is giving tax advice—

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[4] As outlined in our opening brief (at 27), the practical burdens on the IRS in conducting tax audits are enormous and should not be underestimated—especially in the case of annual audits of large multinational corporations. It may be, as respondents state (AY Br. 2, 26; AH Br. 2)—although no findings were made below in this regard—that the tax accrual workpapers do not contain facts that are not otherwise available in Amerada Hess's records or public documents. But that does not mean that the information is to be found in files that are actually produced by the taxpayer. For instance, with respect to a depreciation deduction, it might be necessary to compare the tax treatment in a given year to that over a number of previous years or to the actual useful life of similar items in the taxpayer's experience—information that might not be obtained in the ordinary course of a routine tax audit for particular years. And even if the source files are requested, the salient information buried among the details in that file will not, as a practical matter, necessarily be evident to the IRS agent. An accountant privilege would bar the IRS from effectively and efficiently enforcing the revenue laws by requesting information from more than one source or in the most intelligible and useable form in which it exists.

sometimes as part of a "team" with the client's attorneys —in connection with the preparation of the client's tax return. It is only a coincidence—and, in view of possible conflicts of interest, perhaps an undesirable one—if the same accounting firm that gave "aggressive" tax advice in connection with the preparation of a return is also doing the "independent" audit.) When engaged in the independent audit the accountant is not to be seen as the client's confidential agent. Consequently, no considerations of "fairness" point in the direction of shielding, from the public gaze, the flow of information that passed between the client and the independent accountant in connection with the preparation of this audit.

The point can be illuminated by supposing that the audit was conducted not by the client's "regular" accounting firm, but by an "outside" auditor selected by the Securities and Exchange Commission. Or suppose the securities laws directed the SEC itself to conduct the audit. In such circumstances no claim could be made that "fairness" requires that the IRS be barred from access to tax accrual workpapers prepared in connection with the audit. Similarly, if a tax accrual audit were made by outside lenders asked by the company to provide it with financing,[5] it is clear that no claim of privilege could possibly be raised to prevent the IRS from summoning the resulting workpapers. But the claim of unfairness in this case is no stronger. Here, too, the central point is that the communications between the client and the independent auditor—and the material generated by the auditor based on those communications—arise not in the context of confidential relationships created for the benefit of the client, but in the context of an investigatory and oversight relationship created in order to provide accurate public disclosure of the client's financial condition.

The same point is relevant to show that the IRS is not here attempting to invade the thoughts and strategies of

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[5] See U.S. Br. 28; *Matter of Newton*, 718 F.2d at 1017 n.2; *United States* v. *El Paso Co.*, 682 F.2d 530, 534 n.3 (5th Cir. 1982), petition for cert. pending, No. 82-716.

a prospective opponent in an adversary proceeding—the traditional justification for the work-product rule. The tax accrual workpapers were prepared in connection with Amerada Hess's obligations under the federal securities laws. They were not prepared in contemplation of an adversarial relationship with the IRS. While the workpapers may discuss Amerada Hess's potential tax problems, they were not prepared as part of the process of resolving disputes with the IRS, and the auditor's role in preparing these papers is quite antithetical to the role of lawyers (and accountants) helping a client to resolve disputes with the IRS. The work-product doctrine turns on the purpose for which a document was *prepared*, not the purpose for which it is sought; the fact that a controversy may be emerging between the taxpayer and the IRS at the time the summons is issued does not transform into work-product the tax accrual file that was previously prepared pursuant to the securities laws.

Nor do the contents of the tax accrual workpapers call for the creation of a privilege. The IRS seeks access to documents that are clearly relevant (see pages 17-19, *infra*) to the determination of the correctness of Amerada Hess's tax returns and are regularly prepared in the ordinary course of business in order for Amerada Hess to engage in public securities activities. More specifically, the IRS seeks existing documents that explain the representation that has been made to the public pursuant to federal securities laws that the reserves set aside by the taxpayer are necessary and sufficient to cover its contingent tax liability.[6] It does not offend traditional notions of fair play and justice for the IRS, in administering the self-reporting tax system, to review the materials underlying that representation, any more than it would to give

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[6] In fact, the reserve is required to include only those contingent liabilities that are "probable" and "can be reasonably estimated" in amount. Financial Accounting Standards Board, *Statement on Accounting Standards No. 5: Accounting for Contingencies* § 8 (1975). Thus, inclusion of a contingent tax liability in the reserve indicates that there is a substantial question about the correctness of the taxpayer's return.

the IRS access to ordinary corporate memoranda prepared in the regular course of business (*e.g.*, in anticipation of a stockholders' meeting at which the company's financial situation will be discussed) that contain an analysis of the company's contingent tax liabilities.

The creation of a privilege would be especially inappropriate here because the documents in question were prepared by the independent public auditor with the very idea that they would be subject to disclosure in the event of a challenge under the securities laws. See U.S. Br. 31-33. There can be no question, and respondents do not contend otherwise, that tax accrual workpapers could be examined by the SEC or a private plaintiff in a securities proceeding. These materials should not be cloaked in a confidential mantle in this case simply because it is the IRS that seeks them for a relevant purpose. Given the significant possibility of disclosure that exists entirely beyond the control of the taxpayer or the auditor, it would be unjustified to treat these documents as privileged with respect to the IRS.[7]

b. Respondents also contend (AY Br. 8, 19-20; AH Br. 14-20) that IRS access to tax accrual workpapers would interfere with the objectives of the federal securi-

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[7] We point out that, for the future, the IRS has established guidelines applicable to requests for tax accrual workpapers in civil investigations. See *Guidelines for Requesting Audit or Tax Accrual Workpapers*, [Audit] 1 Int. Rev. Man. (CCH) ¶ 4024.4 (May 14, 1981). While these internal guidelines are not binding and do not give rise to enforceable rights (see, *e.g.*, *United States* v. *I.C. Industries, Inc.*, 555 F. Supp. at 222; *United States* v. *Price Waterhouse & Co.*, 515 F. Supp. at 999; *United States* v. *Arthur Andersen & Co.*, 474 F. Supp. 322, 331 (D. Mass. 1979), appeal of one party dismissed, 623 F.2d 720 (1st Cir.), cert. denied, 449 U.S. 1021, aff'd as to second party, 623 F.2d 725 (1st Cir. 1980)), they do reflect the IRS's sensitivity to and efforts to satisfy the objections that have been raised to summonses for tax accrual workpapers. (The guidelines do not apply to criminal (or joint civil-criminal) investigations, and thus would have been irrelevant to this case even if they had been promulgated when this summons was issued.) The standards set forth in the guidelines are not as restrictive as the qualified privilege that the court below appeared to contemplate (see Pet. App. 31a-32a & n.10).

ties laws and that this tension should be resolved in favor of the primacy of the securities statutes.

A statutory privilege is not to be recognized, however, "unless the statute, strictly construed, requires such a result." *St. Regis Paper Co.* v. *United States*, 368 U.S. 208, 218 (1961). Cf. *Commonwealth Edison Co.* v. *Montana*, 453 U.S. 609, 633-634 (1981); *Local 1976, United Brotherhood of Carpenters* v. *NLRB*, 357 U.S. 93, 111 (1958). Consequently, as discussed in our opening brief (at 42-44), the court of appeals erred in elevating the vague emanations it found in the securities laws over the clear and express authority of the IRS to summon relevant records.

These emanations were based on the highly speculative and conjectural proposition that IRS access to tax accrual workpapers *might* have *some* effect in decreasing the candor of communications between *some* taxpayers and auditors in *some* circumstances (see Pet. App. 29a-30a). We note, again, that the proposition proves too much: it would require shielding tax accrual workpapers developed during an audit even where it is conducted by an "outside" auditor—one picked by the SEC or by creditors or prospective investors.

In any event, this is far too slender a reed on which to limit IRS access under Section 7602. There is serious doubt whether the independent audit process will be impaired by the absence of an accountant privilege for tax accrual workpapers. See U.S. Br. 39-42.[8] A publicly-

[8] Some commentators have noted that the independent audit process is enhanced by the lack of an accountant privilege and that it is the decision below that threatens to impair that process. See, *e.g.*, Jacobson & Steel, *The Auditor Work-Product Privilege*, 16 Review of Securities Regulation 891, 897 (May 18, 1983) ("Public confidence in the audit process may be diminished rather than enhanced by the *Arthur Young* result. The existence of the privilege * * * could put undue pressure on auditors to bend to client pressure, or at least a public perception of such pressure. If the audit trail is shrouded in secrecy, the audit's integrity may be open to question"); Note, *Tax Accrual Workpapers and IRS Summonses Under IRC § 7602: The Accountant Work-Product Privilege*, 48 Mo. L. Rev. 825, 832-833 (1983) ("For the public to have * * * faith

held corporation like Amerada Hess is required by law to file accurate and complete financial statements that have been certified by an independent auditor. This legal duty —and the serious consequences of failing to comply—provides substantial assurance of the adequacy of the audit process irrespective of any privilege. Further, the auditor is obligated to follow generally accepted standards—including requirements with respect to access to adequate information on which to base its opinion—and has effective means at its disposal to obtain the cooperation of the taxpayer. Since accounting standards require that workpapers be prepared and retained, and since a principal purpose of the workpapers is to provide information and protection for the auditor in the event of a later challenge,[9] there is little reason to believe, as the court of appeals feared (Pet. App. 25a), that the possibility of IRS access would induce auditors not to keep such papers.

Finally, in assessing the impact of declining to create an accountant privilege, it should be recognized that there already exist temptations for the taxpayer to try to confine the scope and thoroughness of the independent audit. Public disclosure of a contingent tax liability can have an adverse effect on a company's financial statement, and the taxpayer may seek therefore to minimize the reserve that the auditor finds to be required. Given the inherent tensions that exist between the taxpayer and the auditor, there is considerable doubt whether the incremental con-

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in the reliability of a corporation's financial statements, it is necessary for them to perceive the auditor as an independent professional. * * * A privilege for auditors would tend to destroy the appearance of independence by creating the impression that the auditor is an advocate for the client. Thus, the work-product privilege would seem to do more harm than good to the audit process * * *"). In fact, the absence of a privilege will help to ensure a strict separation between the functions of tax advice on the one hand and tax audits on the other, and thereby safeguard the independence of the audit process.

[9] See, *e.g.*, Wixon, Kell, & Bedford, *Accountants' Handbook* 26:19-26:21 (5th ed. 1970); Report, *A Qualified Privilege for Tax Accrual Workpapers*, 39 Bus. Law. 247, 255 n.31 (1983).

sequences of the absence of an accountant privilege would significantly affect the public audit process.[10]

c. To the extent that the desirability of an accountant privilege is debatable, that debate should be resolved by Congress as the policymaking branch of government. See, *e.g.*, *United States* v. *New Mexico*, 455 U.S. 720, 737-738 (1982); *Diamond* v. *Chakrabarty*, 447 U.S. 303, 317 (1980); *United States* v. *Gillock*, 445 U.S. 360, 374 (1980); *Branzburg* v. *Hayes*, 408 U.S. 665, 693-694, 706 (1972). Congress rather than the federal judiciary is the appropriate body to strike the balance between the conflicting policies—if they are conflicting—of the tax and securities laws. Congress also is better situated to gather and analyze the facts pertaining to the necessity for and scope of an accountant privilege. These would include, on the one hand, the IRS's need for access to tax accrual workpapers and the effect on its enforcement workload and resources of denying such access; and, on the other, the "chilling" effect that the absence of a privilege might have on the independent auditing process and its consequences for the investing public, the preconditions for and bounds of the privilege, and the establishment of judicial and administrative procedures (including the possibility of in camera review in district court) to implement the privilege.

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[10] *Upjohn Co.* v. *United States*, 449 U.S. 383 (1981), upon which respondents rely (AH Br. 19), does not suggest a contrary conclusion. See U.S. Br. 42 n.25. In *Upjohn*, the corporation was under no legal duty to disclose to its attorney the information sought to be protected by the privilege, and its attorney was neither required nor given the authority by law to uncover that information on its own. In contrast, Amerada Hess does have the legal duty—regardless of privilege—to make a full and correct disclosure to the independent public auditor, and the auditor is obligated and provided with effective means to enable it to obtain the necessary information. For these reasons, the Court's concern in *Upjohn* that the "depth and quality of any investigations to ensure compliance with the law would suffer" in the absence of a privilege (449 U.S. at 393 n.2) is inapplicable here. Rather, it is the requirements of the securities laws, not an accountant privilege, that ensure the adequacy of the public accounting process.

In advancing this argument, we do not contend, as respondents characterize it (AY Br. 21-22; AH Br. 21-24), that the courts lack "power" to recognize an accountant privilege. Rather, we suggest that, in light of the speculative nature of the court of appeals' reasoning and its reliance on a supposed conflict between two federal statutory schemes, Congress is in a better position than the judiciary to decide whether a novel accountant privilege is needed to limit the broad statutory summons authority of the IRS. See *Matter of Newton*, 718 F.2d at 1021.[11]

2. Respondents contend (AY Br. 26-31; AH Br. 35-42) that the judgment below may be affirmed on the alternate

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[11] Notwithstanding respondents' argument (AY Br. 18 n.12; AH Br. 30-32), Congress did not resolve the issue in the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 323(a), 96 Stat. 324, 613, which provides a penalty for substantial understatement of income tax unless there is substantial authority for the taxpayer's position or the relevant facts were disclosed by the taxpayer on its return. TEFRA does not answer the question presented here. First, there is no indication that Congress intended to resolve the issue of IRS summons authority; TEFRA speaks to the routine requirements for all tax returns and does not address the narrower class of cases in which an audit is conducted and a summons issued. Furthermore, the sentence in S. Rep. 97-494, 97th Cong., 2d Sess. 274 (1982), upon which respondents heavily rely, was deleted in the Conference Report, H.R. Conf. Rep. 97-760, 97th Cong., 2d Sess. 575-576 (1982). Finally, and perhaps most importantly, the penalty provision in Section 323(a) of TEFRA is not self-enforcing but instead requires the IRS to uncover those taxpayers that substantially underreport their taxes—a matter handled by the investigation and summons process. Thus, the existence of the penalty and its exemption for the disclosure of relevant facts do not in any way suggest that Congress intended to cut back on the IRS's authority to investigate in cases in which such disclosure was not made. Indeed, in other sections of TEFRA explicitly involving the IRS's summons power, Congress generally expanded rather than restricted that power. See H.R. Conf. Rep. 97-760, *supra*, at 583-584. There is no indication in TEFRA that Congress sought to limit the IRS's authority to summon tax accrual workpapers or that it was aware of and meant to choose between, on the one hand, the decisions in this case and *United States* v. *Coopers & Lybrand*, 413 F. Supp. 942 (D. Colo. 1975), aff'd, 550 F.2d 615 (10th Cir. 1977), and, on the other, those in *Arthur Andersen*, *Price Waterhouse*, and *El Paso Co.*

ground that, as a matter of law, tax accrual workpapers are not relevant under 26 U.S.C. 7602. Both courts below correctly rejected this contention (Pet. App. 6a-8a, 26a-27a). See U.S. Br. 21-28.[12]

Section 7602(1) and (2) of the Internal Revenue Code (26 U.S.C.) provides that the IRS is authorized to summon and examine "any books, papers, records, or other data *which may be relevant* or material to [its] inquiry" (emphasis added). All the courts of appeals are in agreement that the standard of relevance under Section 7602 is whether the documents sought "might throw light upon" the IRS's inquiry into the correctness of the taxpayer's return.[13]

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[12] There is some question whether this issue, which was not presented in our petition, is properly raised by respondents in the absence of a granted cross-petition. (The cross-petition that Arthur Young did file (No. 82-837), which remains pending, does not raise the issue of the relevance of tax accrual workpapers.) The rule is well settled "that a party must cross-appeal or cross-petition if he seeks to change the judgment below or any part thereof. An argument which would modify the judgment even in a way that provides less relief cannot be presented without filing a cross-appeal or cross-petition." Stern & Gressman, *Supreme Court Practice* 478 (5th ed. 1978). See, *e.g.*, *Andrus* v. *Idaho*, 445 U.S. 715, 725 n.6 (1980); *United States* v. *New York Telephone Co.*, 434 U.S. 159, 166 n.8 (1977); *FEA* v. *Algonquin SNG, Inc.*, 426 U.S. 548, 560 n.11 (1976); *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 381 n.4 (1970). The ruling below held that the tax accrual workpapers need not be produced in this case because the qualified privilege created by the court of appeals had not been overcome (see Pet. App. 32a); in contrast, a determination that the materials are not relevant would constitute an absolute ground for nonproduction regardless of any showing that the IRS might make. Moreover, if respondents' contention were accepted, it would be appropriate to remand the case for further proceedings to consider whether the tax accrual workpapers, although not relevant in their entirety, may be relevant in any part. Nevertheless, given that the issue of relevance was decided by the courts below and has been briefed in this Court, and given the analytical relationship between respondents' arguments and the question of privilege that is presented in our petition, we have no objection if the Court wishes to reach the issue of relevance.

[13] See, *e.g.*, *United States* v. *Freedom Church*, 613 F.2d 316, 321 (1st Cir. 1979); *United States* v. *Noall*, 587 F.2d 123, 125 (2d

This standard reflects the broad statutory authority conferred upon the IRS to conduct audits. The IRS need not have probable cause to believe that additional taxes are due, but rather " 'can investigate merely on suspicion that the law is being violated, or even just because it wants assurance that it is not.' " *United States* v. *Powell*, 379 U.S. 48, 57 (1964) (citation omitted). Furthermore, "Congress[] inten[ded] to provide the [IRS] with broad latitude to adopt enforcement techniques helpful in the performance of [its] tax collection and assessment responsibilities * * *." *United States* v. *Euge*, 444 U.S. 707, 716 n.9 (1980). And of course, until it has seen them, the IRS cannot be certain that the requested materials will in fact bear on the correctness of the taxpayer's return, and therefore it can do no more than seek documents that "may be relevant" to its investigation (26 U.S.C. 7602). See U.S. Br. 23-24 & n.11.[14]

Cir. 1978), cert. denied, 441 U.S. 923 (1979); *United States* v. *Garden State National Bank*, 607 F.2d 61, 68-70 (3d Cir. 1979); *United States* v. *Richards*, 631 F.2d 341, 345 (4th Cir. 1980); *United States* v. *El Paso Co.*, 682 F.2d 530, 537 (5th Cir. 1982), petition for cert. pending, No. 82-716; *United States* v. *Will*, 671 F.2d 963, 966 (6th Cir. 1982); *United States* v. *Kis*, 658 F.2d 526, 537 (7th Cir. 1981), cert. denied *sub nom. Salkin* v. *United States*, 455 U.S. 1018 (1982); *United States* v. *Matras*, 487 F.2d 1271, 1274 (8th Cir. 1973); *United States* v. *Ryan*, 455 F.2d 728, 733 (9th Cir. 1971); *United States* v. *Southwestern Bank & Trust Co.*, 693 F.2d 994, 996 (10th Cir. 1982); *Matter of Newton*, 718 F.2d 1015, 1019 (11th Cir. 1983); see also *United States* v. *I.C. Industries, Inc.*, 555 F. Supp. 219, 221 (N.D. Ill. 1983).

[14] Amerada Hess notes (AH Br. 37-38) that some courts have added that there must be a realistic expectation, and not simply an idle hope, that the summoned information will assist in determining the taxpayer's correct tax liabilities. We doubt that this addition represents a substantive variation in the standard of relevance. It is simply a common-sense explication of an implicit element of the relevancy test. The "might throw light upon" and the "realistic expectation" formulations are not inconsistent; they are routinely applied together and treated as a single standard.

Respondents assert (AH Br. 2, 37-39; see also AY Br. 2-3, 8-9, 26) that the customary standard of relevance is inapplicable here because the summons was issued to a third party (the accounting

In arguing that tax accrual workpapers are not relevant under 26 U.S.C. 7602, respondents propose a new standard of "'sufficient relevance'" that involves "a

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firm) rather than to the taxpayer, because the tax accrual workpapers were not used in the preparation of the tax returns under audit, and because the factual information contained in the tax accrual workpapers may be in other records of Amerada Hess or public documents that are available to the IRS. However, given the breadth of Section 7602 (see, *e.g.*, *United States* v. *Euge*, 444 U.S. at 712-716) and its applicability to third parties as well as taxpayers (see, *e.g.*, *United States* v. *Bisceglia*, *supra*), we doubt that the fact a summons is issued to a third party instead of to the taxpayer has decisive significance to the issue of relevance. In any event, the court of appeals was correct in concluding that in this case Arthur Young "is not a stranger to Amerada's concerns * * *. [It] was hired to investigate Amerada's financial affairs, and to involve itself in matters that were likely to be the object of governmental inquiry" (Pet. App. 22a). Thus, in the circumstances presented here, Arthur Young does not fall within any special rule for third parties that might exist. See U.S. Br. 23 n.10.

The court of appeals also correctly rejected the argument that documents are not relevant if they were not used in preparing the taxpayer's return (Pet. App. 27a). See U.S. Br. 23 n.10, 39 n.23. Materials not used in a tax return unquestionably "may be relevant * * * [to the Commissioner's] inquiry" under Section 7602, and courts have enforced summonses for such materials. See, *e.g.*, *United States* v. *Euge*, *supra* (exemplar of taxpayer's handwriting); *Donaldson* v. *United States*, 400 U.S. 517 (1971) (employment applications and background data); *United States* v. *New York Telephone Co.*, 644 F.2d 953 (2d Cir. 1981) (telephone company billing records); *United States* v. *Wyatt*, 637 F.2d 293, 300 (5th Cir. 1981) (evidence relating to illegal payments whether or not deducted on the returns); *United States* v. *Noall*, 587 F.2d at 125-126 (internal audit data not used in preparation of returns); *United States* v. *Cleveland Trust Co.*, 474 F.2d 1234 (6th Cir.), cert. denied, 414 U.S. 866 (1973) (net worth statements submitted to bank with loan application); see also *United States* v. *Southwestern Bank & Trust Co.*, 693 F.2d 994 (10th Cir. 1982); *United States* v. *Norcutt*, 680 F.2d 54 (8th Cir. 1982).

Finally, even accepting respondents' statement that the information in the tax accrual files may be found in other sources, this does not suggest that the files are not relevant or that they have in effect already been disclosed to the IRS. Documents do not lose their relevance and become immune from production simply because they collect, summarize, or analyze information that may be uncovered elsewhere in a less convenient or intelligible form—

matter of judgment and degree in light of the particular circumstances of the case," including "the degree of intrusion into a third party's files, the type of materials requested and a balancing of public policies with respect to disclosure" (AH Br. 37; see also AY Br. 29-31). This proposal to alter the traditional test of relevance is unsound for two fundamental reasons.

First, respondents' standard is divorced from the defining characteristic of relevance as a logical relationship between the materials in question and the inquiry at hand. Instead, respondents seek to import into the concept of relevance a host of policy considerations that are customarily and more appropriately treated under other doctrines such as privilege; indeed, many of the concerns identified by respondents as addressed to relevance are also advanced in support of their argument for the creation of an accountant privilege. Such "double counting" is unnecessary and improper. There is no reason to require courts to undertake the same analysis twice under two different headings. The issue of relevance is not independently illuminated by an assessment of factors like intrusiveness, burden, the sensitivity of confidential information or relations, and similar competing policies involved in balancing the needs for disclosure and nondisclosure; these considerations are better handled by other doctrinal means such as privilege.

Second, respondents' proposal represents an amorphous and complex standard that is ill-conceived for resolving the recurring and essential issue of the relevance of an IRS summons. If adopted, respondents' standard would needlessly burden the summons process, would lead to increased uncertainty and litigation, and would greatly delay the completion of the "summary enforcement proceeding." *Donaldson* v. *United States*, 400 U.S. 517, 529

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especially where, as here, the tax accrual workpapers may cast doubt upon the reliability of the taxpayer's records. See, *e.g.*, *United States* v. *Silvestain*, 668 F.2d 1161, 1163 (10th Cir. 1982); *United States* v. *Daffin*, 653 F.2d 121, 124 (4th Cir. 1981); *United States* v. *Davis*, 636 F.2d 1028, 1037-1038 (5th Cir.), cert. denied, 454 U.S. 862 (1981).

(1971); see also *United States* v. *LaSalle National Bank*, 437 U.S. 298, 316 (1978). For these reasons, respondents' standard should be rejected.

In applying the traditional standard of relevance to tax accrual workpapers, every court but one to consider the issue has agreed with the decision below that such materials are relevant within the meaning of Section 7602.[15] These decisions are plainly correct. The workpapers would clearly be relevant under the conventional standard

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[15] See *Matter of Newton*, 718 F.2d at 1018-1020; *United States* v. *El Paso Co.*, 682 F.2d at 536-538; *United States* v. *Price Waterhouse & Co.*, 515 F. Supp. 996, 999-1000 (N.D. Ill. 1981); *United States* v. *Arthur Andersen & Co.*, 474 F. Supp. 322, 329-330 (D. Mass. 1979), appeal of one party dismissed, 623 F.2d 720 (1st Cir.), cert. denied, 449 U.S. 1021, aff'd as to second party, 623 F.2d 725 (1st Cir. 1980); cf. *In re Grand Jury Subpoenas Duces Tecum (Charles Rice)*, 483 F. Supp. 1085, 1088-1089 (D. Minn. 1979) (grand jury subpoena for tax accrual workpapers).

The one case to the contrary is *United States* v. *Coopers & Lybrand*, 413 F. Supp. 942, 947-954 (D. Colo. 1975), aff'd, 550 F.2d 615, 619-621 (10th Cir. 1977), which turned on its particular facts. In that case, the government advanced four principal reasons for seeking the tax accrual workpapers. The taxpayer introduced evidence to rebut that showing, and the government "did not seek to refute this contention, but then took the position that the [workpapers] might shed some light on other, yet unidentified, areas of tax liability" (413 F. Supp. at 951). Based on this record, the district court denied enforcement, concluding that there had to be "some justifiable expectation that the information sought is relevant to the purpose of the inquiry" (*id.* at 952) and that "the term 'relevance' connotes and encompasses more than 'convenience'" (*id.* at 947, citing *United States* v. *Matras*, 487 F.2d at 1275). The court of appeals affirmed, stating that "a district court's determination that a summons should not issue must stand unless determined to be clearly erroneous" (550 F.2d at 620). To the extent that the opinions in *Coopers & Lybrand* can be read to have broader implications, they have been rejected, as noted above, by every other court to consider the issue of tax accrual workpapers. See also *United States* v. *Noall*, 587 F.2d at 126-127. Furthermore, insofar as *Coopers & Lybrand* depended upon the fact the workpapers had not been used in the preparation of the taxpayer's return (413 F. Supp. at 950, 952, 954; 550 F.2d at 619, 621), it has not been followed by other circuits or by the Tenth Circuit in subsequent cases. See U.S. Br. 39 n.23; see also page 14 note 14, *supra*.

for civil discovery in Fed. R. Civ. P. 26(b)(1); surely the IRS has no lesser authority under Section 7602.[16]

Tax accrual workpapers are relevant in several ways. See U.S. Br. 24-27. First, respondents recognize (AY Br. 2, 26; AH Br. 2) that these workpapers contain factual information; "tax accrual papers * * *, even though they consist in part of projection and hypotheses, also deal with facts and figures that form the basis of Amerada's tax liability, which the IRS desires to verify" (Pet. App. 9a). And the workpapers can be expected to present the relevant information in an organized and coherent way (see U.S. Br. 25-26); the fact that the same information may also be found in some form scattered throughout the taxpayer's voluminous files, as respondents represent (see page 4 note 4, *supra*), surely does not undermine its relevance.

In addition, tax accrual workpapers can include admissions or concessions by the taxpayer as to its tax liability. As the court of appeals noted (Pet. App. 29a), included in the information the taxpayer discloses to its independent auditor may be "questionable positions [it took] on [its] tax returns." Any acknowledgment by

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[16] Respondents argue (AY Br. 26; AH Br. 36) that tax accrual workpapers are not relevant insofar as they are sought to further the "convenience" of the IRS in conducting an audit and provide a "roadmap" through the data and issues involved in the audit. We disagree. In fact, it is common practice with respect to subpoenas and civil discovery for the requesting party both to seek information in the most convenient form in which it exists (*e.g.*, in computer-readable form, or in summaries and compilations rather than raw data) and to seek aids to facilitate the requester's use and undertanding of other materials (*e.g.*, organization charts, indices and descriptions of files, or computer instructions used in generating data). Furthermore, as Fed. R. Civ. P. 26(b)(1) expressly recognizes, information is relevant if it "appears reasonably calculated to lead to the discovery of admissible evidence" that tends to prove or disprove any fact at issue in the litigation. The IRS, in enforcing the revenue laws, is entitled to no less latitude. Accordingly, materials that assist the IRS in conducting an audit, by focusing its attention and limited resources and by leading it to information bearing on the taxpayer's liability, are relevant.

the taxpayer that the position taken on its return was "questionable" is highly relevant to the issue of its tax liability.

Likewise, tax accrual workpapers can bear on the taxpayer's state of mind in submitting its returns, which is directly relevant to the imposition of various penalties and sanctions (see U.S. Br. 25 & n.13). This relevance is not negated, as respondents assert (AY Br. 2, 8-9; AH Br. 2, 4), by the fact that the workpapers are generally prepared subsequent to the filing of the return for a given year, for they may shed light on the taxpayer's state of mind in succeeding years. In this case, for example, the workpapers for the tax year 1972 may shed light on the taxpayer's intent if the taxpayer failed to heed the auditor's advice in its 1973 and 1974 returns. Nor do the tax accrual workpapers become irrelevant simply because the IRS did not allege fraud or other grounds for penalties at the time it issued the summons (see AH Br. 4, 5). As this Court has recognized, a tax investigation inquires into all aspects of the taxpayer's liability under the Internal Revenue Code, including its liability for fraud or other penalties, and does not require an advance determination by the IRS of reason to believe that fraud or other violations have occurred. See *United States* v. *LaSalle National Bank*, 437 U.S. at 308-309; *United States* v. *Bisceglia*, 420 U.S. at 146; *United States* v. *Powell*, 379 U.S. at 53-54, 56-58. A contrary rule would force the IRS to resolve "the very subject which [it] desires to investigate" (*id.* at 54) and necessitate " 'forecasts of the probable result of the investigation' " (*id.* at 57 (citation omitted)).[17]

Tax accrual workpapers are also relevant because they reveal the analysis and opinions of the independent auditor on the correctness of the taxpayer's return. The informed judgment of an independent certified public accountant on that question is plainly *relevant*. As the court of appeals explained (Pet. App. 27a), "[i]t is dif-

[17] We note, in addition, that the IRS was conducting both civil and criminal investigations in this case (see Pet. App. 19a-20a).

ficult to say that the assessment by the independent auditor of the correctness of positions taken by the taxpayer in his return would not throw 'light upon' the correctness of the return." See also *Matter of Newton*, 718 F.2d at 1020; *United States* v. *El Paso Co.*, 682 F.2d at 537; cf. *United States* v. *Noall*, 587 F.2d at 126. While it is not the purpose of the summons to obtain such materials (see U.S. Br. 26-27), they are plainly not irrelevant.

Finally, the tax accrual workpapers may contain discussions by the auditor and taxpayer pertaining to settlement and litigation of potential tax disputes. This information "may be relevant" under Section 7602 since it will normally incorporate or reflect an assessment of facts and their legal consequences—as, for example, where the auditor recommends that the taxpayer pay the full amount of the tax due because of the weakness of the position taken on the return. Of course, in some instances this type of information will not prove to be pertinent—for example, where the decision "not to litigate * * * [is] based on considerations wholly apart from the inherent legality of what the taxpayer has done, e.g., the cost of * * * litigation * * *" (Pet. App. 30a).[18] Indeed, as respondents point out (AY Br. 29; AH Br. 34), the Service itself has recognized that the "examiner's interest in the 'items' that make up the tax accrual does not include the independent accountant's or taxpayer's opinion of the value of issues or the likelihood of success in litigation." IRS Information Notice 80-7 (Aug. 4, 1980). But the fact that this portion of the workpapers will not be relevant in all cases does not automatically exempt it from production (or at least in camera review) and does not in any way warrant the withholding of the remainder of the papers.[19]

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[18] It is hardly a proprietary secret, however, or outside the common understanding of the IRS, that a taxpayer is unlikely to undertake costly litigation to contest relatively small tax liabilities.

[19] We emphasize that, even if some small portions of the workpapers are not relevant, the proper disposition would hardly be to

For the foregoing reasons and those stated in our opening brief, it is respectfully submitted that the judgment of the court of appeals should be reversed.

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withhold the materials altogether. Rather, the general rule regarding the production of documents to the government is that, at least in the absence of special considerations, the government is entitled to see the entirety of any document that contains relevant material. Even if that customary procedure were inapplicable here, at most petitioners would be allowed to withhold those portions of the workpapers—perhaps subject to in camera review by the district court—that do not meet the proper standard of relevance.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

UNITED STATES OF AMERICA,

Petitioner,

—against—

ARTHUR YOUNG & COMPANY, et al.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS *AMICUS CURIAE*

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QUESTION PRESENTED

The question presented by this appeal, and addressed by the Institute as *amicus curiae* in this brief, may be reformulated as follows:

> Whether sensitive and confidential "tax accrual workpapers," prepared by the taxpayer's independent certified public accountant during the course of an audit of the taxpayer's financial statements, are routinely discoverable pursuant to an Internal Revenue Service summons absent an actual and particularized need for the information contained in those workpapers.

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ARTHUR YOUNG & COMPANY, et al.,

Respondents.

BRIEF OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS AS *AMICUS CURIAE*

PRELIMINARY STATEMENT

The American Institute of Certified Public Accountants (the "Institute") submits this brief as *amicus curiae*, addressed to the issue specified above, and urges this Court to affirm the order of the Court of Appeals for the Second Circuit, entered on April 13, 1982, which reversed the order of the District Court for the Southern District of New York enforcing the Internal Revenue Service ("IRS" or the "Service") summons, to the extent that the District Court order required Respondent Arthur Young & Company ("Arthur Young") to produce the "tax accrual" or "tax reserve" workpapers which it prepared in the course of its audits of the financial statements of Respondent Amerada Hess Corporation ("Hess").[1]

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[1] This brief is submitted upon consent of the parties pursuant to Rule 36.1 of this Court. The written consent of the Petitioner is contained in a

INTEREST OF THE INSTITUTE AS *AMICUS CURIAE*

The Institute is the only national accounting association whose membership is limited to certified public accountants; it has approximately 200,000 members. Among its purposes are the promotion and maintenance of high professional standards of practice and the development of Generally Accepted Auditing Standards ("GAAS").[2] It regularly identifies and addresses issues important to the independent public accounting profession.

Such an issue is presented here. The Service's attempts to seek the production of auditors' tax accrual workpapers has generated tension between the asserted need of the Service to obtain information from these tax accrual workpapers to assist it in sorting through the data in its possession, and the need on the part of public investors, as well as others, for auditors to retain reasonably uninhibited access to the information necessary to conduct a thorough and effective audit of corporate financial statements.

The issue presented by this appeal transcends the individual interests of the particular litigants at bar and is of fundamental concern to the auditing profession as a whole. Its ultimate resolution here will affect the practice of auditors charged with

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letter from the Solicitor General dated August 30, 1983. We are informed that the written consent of both Respondent Arthur Young & Company and Respondent Amerada Hess Corporation is contained in a letter from counsel which Respondent Arthur Young & Company has separately filed with the Court.

2 Generally, GAAS establishes "general standards of conduct relating to the Auditor's professional qualities as well as to the judgments exercised by him in the performance of his examination and issuance of his report." AICPA STATEMENT ON AUDITING STANDARDS NO. 1, § 150.01 (1972). One such judgment is the auditor's opinion that the statements reflect the consistent application of generally accepted accounting principles ("GAAP"). These principles govern the presentation in the financial statements of the transactions, assets and liabilities reflected on the books and records of an entity.

auditing financial statements and with compliance with the Securities Laws.[3]

The Institute recognizes not only the need to protect the confidentiality of tax accrual workpapers prepared by independent auditors, but also the significant public interest in the proper enforcement of the revenue laws and the maintenance of the public fisc. Accordingly, the purpose of the Institute's participation in this case as *amicus curiae* is to present an approach that will accommodate these competing interests consistent with both the law and public policy involved.

The analysis proposed by the Institute in this brief focuses upon the relevancy of the documents summoned by the IRS and resolves the competing interests essentially by balancing the Service's need for production thereof against the hardship that disclosure would impose. The alternative analysis presented in this brief does not conflict with the work product analysis applied by the Second Circuit in support of its decision shielding tax accrual workpapers from the reach of IRS summons power. As will become clear from the following discussion, the underlying policy concerns that prompted the court below to protect the confidentiality of these workpapers are the precise policy considerations that provide the fulcrum for the balancing approach espoused by the Institute.

By proposing a flexible balancing approach focused on relevancy, the Institute does not suggest that the application of a work product privilege to the present facts would be in any way inappropriate. The Institute believes that it would be appropriate and desirable for this Court to adopt either the approach espoused by the court below or the alternative approach presented in this brief. The Institute is cognizant of the existence of considerable authority permitting, if not mandating, the judicial construction of common-law disclosure

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3 As employed herein, the term "Securities Laws" includes the Securities Act of 1933, 15 U.S.C. § 77(a) *et seq.* (1976) (the "1933 Act"), the Securities Exchange Act of 1934, 15 U.S.C. § 78(a) *et seq.* (1976) (the "1934 Act"), and the regulations promulgated thereunder.

privileges under the proper circumstances, and is supportive of the narrow application of a work product privilege to shield the tax accrual workpapers at issue here from the reach of the IRS summons power.

STATEMENT

As a public company, Hess is required to have its books and records audited in accordance with GAAS and pursuant to various rules and regulations issued by the Securities and Exchange Commission ("SEC"). Arthur Young has served as independent auditor to Hess since 1971.

The IRS served a summons (A. 15-16)[4] on Arthur Young in 1978 pursuant to Section 7602(a) of the Internal Revenue Code, 26 U.S.C. § 7602(a) (1976), *as amended by* Act of Sept. 3, 1982, Pub. L. No. 97-248, tit. III, § 333(a), 96 Stat. 622 (1982). ("Section 7602(a)").[5] It sought, *inter alia*, Arthur Young's audit workpapers for the years 1972, 1973 and 1974. Among the audit workpapers demanded was Arthur Young's "tax pool analysis" file for each year.

On the motion by the IRS before the United States District Court for the Southern District of New York to compel production of the various documents summoned, the IRS case manager confirmed that the tax pool analysis file was sought essentially so that in reviewing the Hess books and records, the IRS would have access to "the specific items of questionable deductibility that the taxpayer possibly claimed for the relevant tax years" identified by Arthur Young in the course of its audit. (A. 78). The record is clear that "[t]here is no factual data relating to Amerada transactions in the tax accrual papers which is not otherwise available in the taxpayer's records or in publicly available documents." (A. 31-32, 38).

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4 Citations (A. ____) are to the pages of the Joint Appendix.

5 Section 7602(a) is set forth in its entirety in the Appendix to this brief.

Notwithstanding its extensive familiarity with Hess, gleaned from access to Hess' books and records, Hess' banking records and responses to 398 information requests (A. 40-46, 50, 63-65, 86), the IRS has yet to identify what factual information it still needs and now seeks from the Arthur Young tax accrual workpapers. Instead it has represented that its "agents did not know what they wanted and that they, therefore, needed to look at everything." (A. 25, 83).

Similarly, the Service's position in the district court was that preparation of the records in question by third parties, rather than by the taxpayer itself, "has no relevance to the scope of the summons." (A. 84, 85).

The Decisions Below

Despite these unsupported assertions of relevance and need, the district court enforced the summons with respect to the tax accrual workpapers and other Arthur Young audit workpapers. A divided panel of the court of appeals reversed this determination to the extent that the lower court's order required production of the tax accrual workpapers. The court held that, relevancy aside, "these documents should remain confidential in order to protect the reliability of the independent audit process" unless the IRS demonstrated a compelling need for them. 677 F.2d at 214.

Rather than apply a flexible relevancy concept that would balance the IRS' need for the information sought against the burden disclosure by a third party would entail as a test of relevancy[6], the court, following *Hickman* v. *Taylor*, 329 U.S. 495 (1947), and Rule 26 of the Federal Rules of Civil Procedure, adopted what is in effect a similar approach by formulating an "accountant work product" privilege requiring the

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6 Although the court noted that the particular question of the relevancy of tax accrual workpapers had not yet been decided in the Second Circuit, 677 F.2d at 219 n.8, it nonetheless felt constrained to apply the minimal relevancy standard established in its earlier decisions. *See, e.g., United States* v. *Noall*, 587 F.2d 123 (2d Cir. 1978), *cert. denied*, 441 U.S. 923 (1979) (summons directed to taxpayer).

Service to make the same showing of necessity to obtain production of the documents. Since the IRS had not made the requisite showing in this case, notwithstanding its access to Hess' own books and records and to the bulk of Arthur Young's audit workpapers, the court reversed.

Tax Accrual Workpapers and Their Relationship to the Audit Process

Tax accrual workpapers contain materials gathered or prepared by an independent auditor as part of an audit and concern only the adequacy of a client's provision on financial statements for potential tax liability. They are not prepared in connection with the preparation of the client's tax returns.

Accruals for unpaid taxes are an integral component of the financial statements required to be filed by registrants with the SEC (Section 12 of the 1934 Act, 15 U.S.C. § 78(1) (1976) and Regulation S-X, 17 C.F.R. § 210.1-01 *et seq.* (1982)). Whenever an auditor expresses an opinion on financial statements, he must evaluate the tax accrual of any public corporation. FINANCIAL ACCOUNTING STANDARDS BOARD ("FASB") STATEMENT NO. 5 (1975); AICPA STATEMENT ON AUDITING STANDARDS NO. 1 (1972).

Both the creation of a tax liability accrual and the auditor's opinion of the sufficiency of that accrual entail the exercise of judgment. As part of that exercise, the auditor examines a client's records and interviews a client's personnel or counsel, focusing upon the tax consequences of transactions and the potential liabilities that could be asserted by the Service.

Disputes with the IRS are not uncommon. IRS adjustments, made pursuant to tax audit, arise from numerous causes, including honest differences in opinion and IRS disagreements with the courts. (A. 28-29). The auditor and client attempt to identify such potential differences in opinion as a preliminary matter. (A. 28). The auditor then develops a series of positions that the IRS could take, discusses them freely with corporate personnel (A. 30), reviews the underlying facts (A. 31), discusses those facts with the client (*id.*), forms his own judgment whether the accrual for unpaid taxes is likely to be sufficient to

cover potential liabilities, and then documents the basis for his conclusion in his workpapers. When the auditor has discharged his duties in accordance with GAAS, he may render an unqualified opinion if and only if he is satisfied that the tax accrual is not materially insufficient to cover all tax assessments that probably must ultimately be paid that are capable of reasonable estimation. *See* FASB STATEMENT NO. 5, *supra*.

As this submission will demonstrate, the integrity and effectiveness of the audit process outlined above relies upon the assurance of the confidentiality of these communications and judgments. Access by the IRS to such communications and judgments would impair the auditor's ability to make these evaluations. The record shows, without contradiction:

> Clients would be reluctant to provide necessary information in the area of the tax accruals for fear that the IRS would routinely obtain this information and then indiscriminately challenge every tax position taken by it. The devastating impact of this to the auditing profession and to the primary objective of that audit, the integrity of the financial statements, is obvious.

(A. 32).

The adverse impact of IRS discovery of tax accrual workpapers prompts the Institute's *amicus* participation. The Institute's concern regarding the implications of IRS access to tax accrual workpapers is not limited to the large clients of large accounting firms; it affects any client which has its financial statements audited by independent accountants and files tax returns. The profession is thus keenly aware of and deeply concerned by the increasing reticence that this issue injects into the auditor-client relationship at all levels.

SUMMARY OF ARGUMENT

The task of articulating a standard for determining whether specific information or documentation "may be relevant" to the ascertainment of the accuracy of a tax return under investigation within the meaning of the precise language of Section 7602(a) now finally reaches this Court in the context of the most recent IRS attempt to force independent accountants to disclose sensitive and confidential "tax accrual workpapers" prepared during the course of a mandatory audit of corporate financial statements.

The court below ultimately held that the tax accrual workpapers prepared by Arthur Young were conditionally immune from the reach of IRS summons power based upon the application of an "accountant work product" privilege. This Court should affirm the result. It may reasonably do so on the analysis of the Second Circuit. Alternatively, the Court can resolve the tension of competing aspects of the public interest involved here by use of a similar analysis of the threshold question of whether such documents should be deemed relevant to the Service's investigation of Hess' tax liability in light of policy considerations. This in turn involves consideration of whether the documents should be ordered disclosed when they are sought from a third party and not the taxpayers, when they are sought for convenience rather than out of any demonstrable necessity, and when their production will impede the auditor's ability to function and thereby simultaneously denigrate significant countervailing Congressional policies.

Statutory analysis compels the conclusion, supported by the more carefully considered decisions of the lower federal courts and IRS internal guidelines, that tax accrual workpapers prepared by independent auditors are not relevant to an IRS tax investigation absent an actual demonstration that any transactional information contained therein needed to assess the correctness of the return in question is not otherwise available from the taxpayer's own books and records. This approach accords with a proper effectuation of the Congressional con-

cerns implicit in the enactment of Section 7602(a), and, because it enables the IRS to obtain specified portions of the accrual workpapers upon a showing of true need, comports with the Congressional grant of broad summons authority reflecting the Service's need for reasonably uninhibited access to information necessary to enforce the revenue laws.

Tax accrual workpapers reflect communications conveyed to the independent auditor with a distinct expectation that the information will remain confidential. The independent audit process is a delicate and difficult endeavor due in large part to the great degree of subjectivity involved in the various decisions that must be made during the course thereof. It is the Institute's belief, founded on the experience of its members and on the record in this case, that if the client's personnel and counsel believed that their comments and conjecture would be freely available to examining IRS agents simply for the asking, the open and candid exchange between clients and auditors, so vital to the effectiveness of the already complex audit process, would be inhibited.

Accordingly, and notwithstanding the existence of various independent legal duties that provide incentive for continued minimum compliance with the Securities Laws, the depth and quality of the independent auditor's tax accrual analysis will be impeded if these workpapers are subject to routine disclosure to the IRS. An absolute discoverability rule will make it more difficult for auditors to fulfill their professional duty, in the public interest, of examining and testing the adequacy of tax accruals and may impugn the reliability of the provision for these tax accruals reflected in financial statements. Such a result is unnecessary, for the flexible balancing approach urged by the Institute, which provides for IRS access to specified portions of tax accrual workpapers prepared by independent auditors upon a particularized demonstration of actual need, effectively accommodates the varying interests of the IRS, the taxpayer and the independent auditor without unduly burdening any of those entities.

The decision below should be affirmed.

ARGUMENT

POINT I

NON-TRANSACTIONAL DOCUMENTS SUMMONED FROM THIRD PARTIES DO NOT SATISFY THE RELEVANCY REQUIREMENT OF SECTION 7602(a) UPON A MERE SHOWING THAT THE DOCUMENTS "MIGHT THROW LIGHT UPON" THE CORRECTNESS OF THE TAXPAYER'S RETURN.

A. IRS Summonses are not Self Executing; Congress Required that the Courts Determine the Relevancy of the Documents Sought.

The broad investigative powers vested in the IRS by virtue of Section 7602(a) are not unlimited. Despite the import of its mission, the Service has not yet received from Congress the right to *carte blanche* discovery, even from taxpayers and certainly not from third parties. This Court has itself emphasized that the summons power of the IRS " 'is a limited power and should be kept within its proper bounds.' " *United States* v. *Bisceglia*, 420 U.S. 141, 151 (1975).

In recognition of the inherent danger that "the authority vested in tax collectors may be abused, as all power is subject to abuse", Congress entrusted the enforcement of IRS summonses to the exclusive supervisory responsibility of the federal courts. *Id.* at 146. That supervisory responsibility obligates the courts to scrutinize challenged summonses with care to guarantee that the scope and nature of official demands for evidence comply with the limitations established by the statute and the policy limitations implicit in providing for judicial review. *See id.*; *United States* v. *Powell*, 379 U.S. 48, 57-58 (1964); *Reisman* v. *Caplin*, 375 U.S. 440 (1964).

B. Enforcement of an IRS Summons With Respect to Documents Sought from Third Parties that do not Contain Transactional Information Should be Denied Unless the IRS Demonstrates an Actual and Particularized Need for the Information Demanded.

1. Relevancy Under Section 7602(a) is not Open Ended.

Congress has authorized the Internal Revenue Service to summon the production of "books, papers, records, or other data which may be relevant or material" to an appropriate IRS inquiry. That standard, however, does not suggest that mere speculation as to relevancy will suffice to justify enforcement of an IRS summons under the statute. Rather, a summons pursuant to Section 7602(a) may not be enforced unless "the Commissioner. . .[can] show that the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, [and] that the information sought is not already within the Commissioner's possession." *United States* v. *Powell*, 379 U.S. at 57-58; *accord United States* v. *Bisceglia*, 420 U.S. at 146. These standards provide an ample basis for precluding disclosure of the Arthur Young tax accrual workpapers.

2. Tax Accrual Workpapers are not "Books, Papers, Records, or Other Data" Within the Meaning of Section 7602(a).

As in every case of statutory construction, in order to determine if the relief sought is authorized, the inquiry must commence with analysis of the statute itself. *E.g.*, Frankfurter, *Some Reflections on the Reading of Statutes*, 47 COLUM. L. REV. 527, 543 (1947). Here Section 7602(a) limits the scope and nature of the information which the IRS may examine to "books, papers, records, or other data." 26 U.S.C. § 7602(a)(1).

The plain language of the statute thus indicates that the nature of the "books, papers, records" available to the IRS is confined to "data"; it provides no indication that the mental conjecture, speculation and thought processes reflected in the

accrual workpapers and which form the basis for the auditor's opinion as to the adequacy for the client's reserve for taxes are to be discoverable.[7] Although the rule of *ejusdem generis*, long recognized by this Court, *e.g.*, *Mason* v. *United States*, 260 U.S. 545, 553-54 (1923), and by common law, 2A C. SANDS, SUTHERLAND STATUTORY CONSTRUCTION § 47.17 (4th ed. 1973), invites such a construction, no resort to that principle is necessary here for, as a former Commissioner of Internal Revenue has put it, "what comes to mind in the use of that term are items such as books, records and other factual materials—not opinions, projections, conjectures and other thought processes." Caplin, *Should The Service Be Permitted To Reach Accountant's Tax Accrual Workpapers?*, 51 J. TAX'N 194, 199 (1979) [hereinafter Caplin, *Tax Accrual Workpapers*].

A tax audit depends on the gathering of factual information; differing interpretations of that information in light of the Code and regulations are judgmental and the gist of tax litigation. The plain meaning of the statutory language supports the view of the Institute that unlimited access to the tax accrual workpapers need not be afforded. In refusing to require the disclosure of tax accrual workpapers on the record before it, the court below was correct and should be affirmed.

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7 Although not defined by the Internal Revenue Code, the term "data" is generally defined as "factual information" (as measurements or statistics) used as a basis for reasoning discussion or calculation. . . ." WEBSTER'S NEW COLLEGIATE DICTIONARY 286 (1981). The term, moreover, has not been construed by this Court. Although recently asked to consider whether handwriting exemplars constituted "other data" within the meaning of the statutory language in *United States* v. *Euge*, 444 U.S. 707 (1980), this Court did not reach that issue, for it concluded that providing such exemplars was required by the statutory duty "to appear . . . and give such testimony . . . as may be relevant or material to such inquiry" under Section 7602(a). *Id.* at 710-11 n.4. In any event, a handwriting exemplar is clearly factual information rather than conjecture or speculation.

3. Convenience to the Service is an Insufficient Predicate for the Enforcement of a Summons When the Documents Sought do not Constitute Records of Transactions Upon Which Tax Liability is Established.

It similarly follows from the statutory reference to "other data" that the IRS is not entitled to information it seeks for convenience purposes. Numerous lower courts have thus applied the relevancy concept of *United States* v. *Powell* to rule that Section 7602(a) was not intended to permit the IRS to obtain the benefit of the summoned party's research by demanding the documents in which its fruits are contained, merely for the purpose of simplifying the performance of the Service's tasks. *United States* v. *Humble Oil & Refining Co.*, 518 F.2d 747, 749 (5th Cir. 1975); *accord United States* v. *Davey*, 543 F.2d 996 (2d Cir. 1976); *United States* v. *Matras*, 487 F.2d 1271 (8th Cir. 1973); *Mays* v. *Davis*, 7 F. Supp. 596 (W.D. Pa. 1934). As explained by the Eighth Circuit in denying further production of materials additional to the taxpayer's books and records, recognition of convenience as the touchstone of relevancy under Section 7602(a) would provide the IRS with the self-executing *carte blanche* discovery power withheld by Congress:

> [T]he government should not, for the mere sake of its convenience, impose unnecessary burdens on a *taxpayer* in conducting an audit or investigation for tax liability, particularly where, as here, there is no indication of a purpose to escape any tax liability. The term "relevant" connotes and encompasses more than "convenience." Consequently, we are not persuaded to fault the district judge for concluding that the government failed to sustain its burden of proof by alleging a general need for a "road map." *If we were to accede to the government's view, it is difficult to imagine corporate materials that might not contribute to a more comprehensive understanding of the workings of the corporation, and thus, according to the government, be deemed relevant to the tax investigation.*

United States v. *Matras*, 487 F.2d at 1275 (emphasis supplied). The Eighth Circuit's reasoning against imposing unnecessary burdens upon a taxpayer for the mere convenience of the IRS is all the more forceful where, as here, the summons is directed to a third party.

This limitation also flows from the statutory language. Section 7602(a) requires a showing of potential relevance to the subject matter of the inquiry. As explained by Judge Garwood in his concurring and dissenting opinion in *United States* v. *El Paso Co.*, 682 F.2d 530 (5th Cir. 1982), *petition for cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716):

> Accordingly, "such inquiry" or "such question" is properly understood as referring to the question of "the correctness of any return" or "the liability of any person for any internal revenue tax." Thus, the section means that the books, papers, records or other data which the Service may summon are only those that it seeks because of their potential relevance to the *correctness* of a return or the *liability* of any person for a tax, as opposed to those the Service seeks merely because they have the potential of facilitating or making more efficient the process of examination.

Id. at 546-47 (emphasis in original) (footnotes omitted); *see also* Note, *IRS Access to Tax Accrual Workpapers: Legal Considerations and Policy Concerns*, 51 FORDHAM L. REV. 468, 479 (1982) [hereinafter *IRS Access to Tax Accrual Workpapers*].

4. A More Substantial Showing of Relevancy Should be Required When Documents are Sought Under Section 7602(a) from Third Parties than is Required When Summonses are Directed to the Taxpayer.

The more carefully reasoned lower federal court opinions have also recognized that judicial oversight is particularly appropriate when IRS summonses are directed to third parties, ruling that the burden imposed upon the bystander requires a fuller and more particularized demonstration of relevancy in

order to obtain enforcement. *E.g.*, *Hubner* v. *Tucker*, 245 F.2d 35, 40 (9th Cir. 1957); *United States* v. *Goldman*, 453 F. Supp. 508, 512 (C.D. Cal. 1978), *aff'd*, 637 F.2d 664 (9th Cir. 1980). These courts have thus required the Service to satisfy the reviewing court that it has a true need for information which justifies the hardship imposed upon the third party through the forced disclosure of the summoned information. *United States* v. *Southwestern Bank & Trust Co.*, 693 F.2d 994, 996 (10th Cir. 1982); *United States* v. *Coopers & Lybrand*, 550 F.2d 615 (10th Cir. 1977); *United States* v. *Humble Oil & Refining Co.*, 488 F.2d 953 (5th Cir. 1974), *vacated*, 421 U.S. 943, *aff'd*, 518 F.2d 747 (5th Cir. 1975); *United States* v. *Egenberg*, 443 F.2d 512, 515 (3d Cir. 1971); *Venn* v. *United States*, 400 F.2d 207, 211-12 (5th Cir. 1968); *United States* v. *Harrington*, 388 F.2d 520 (2d Cir. 1968); *Hubner* v. *Tucker*, 245 F.2d at 41; *Local 174, International Brotherhood of Teamsters* v. *United States*, 240 F.2d 387, 390 (9th Cir. 1956); *United States* v. *Williams*, 337 F. Supp. 1114, 1116-17 (S.D.N.Y. 1971), *appeal dismissed and vacated mem.*, 486 F.2d 1397 (2d Cir. 1972); *In re Carroll*, 149 F. Supp. 634, 637-38 (S.D.N.Y.) (*dictum*), *aff'd*, 246 F.2d 762 (2d Cir.), *cert. denied*, 355 U.S. 857 (1957).

The critical holding in *United States* v. *Coopers & Lybrand*, 550 F.2d 615 (10th Cir. 1977), *aff'g* 413 F. Supp. 942 (D. Colo. 1975), supports this balancing approach. There, the Tenth Circuit affirmed the district court's denial of enforcement of an IRS summons demanding production of an independent certified public accountant's audit program and tax pool analysis file (containing tax accrual workpapers). The district court, in refusing to enforce the summons, emphasized that "considerations of policy and burdensomeness" were relevant in the context of judicial enforcement proceedings and indeed were factors to be weighed against the necessity for and relevancy of the information as averred by the IRS. 413 F. Supp. at 948. In applying that test, the district court found that the IRS had uninhibited access to all transactional documents. *Id.* at 949. It further found that "[t]he information contained in the Tax Pool is conjectural and theoretical", *id.* at 953, noting that these papers generally contain "the worst possible

nightmare" the client can conceive can happen if every assumption on which he based his tax were to go against him in some kind of litigation, *id.*, and presciently observed that production would unnecessarily impede the auditor's ability to perform. *Id.* at 954.[8]

Although virtually every business transaction with a third party is reflected on a corporation's tax return, third parties do not assume responsibility for the accuracy of the return simply by conducting business with the taxpayer; nor are they reasonably to believe that by doing so they will be forced to comply with the same broad IRS discovery power to which the taxpayer is subjected. Third parties should not be forced to bear, as a cost of having done business with the taxpayer, the burden of routine inquiry, especially when the information needed to assess the accuracy of the taxpayer's return is otherwise readily available to the Service from the taxpayer's own books and records. *See United States* v. *Theodore*, 479 F.2d 749, 754 (4th Cir. 1973); *accord United States* v. *Coopers & Lybrand*, 550 F.2d at 621; *United States* v. *Humble Oil & Refining Co.*, 488 F.2d at 963.

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8 The authority of *Coopers & Lybrand* is not diminished by the Second Circuit's decision in *United States* v. *Noall*, 587 F.2d 123 (2d Cir. 1978), *cert. denied*, 441 U.S. 923 (1979), or by the Massachusetts district court's ruling in *United States* v. *Arthur Andersen & Co.*, 474 F. Supp. 322 (D. Mass. 1979), *appeal dismissed as moot*, 623 F.2d 720 (1st Cir.), *cert. denied*, 449 U.S. 1021 (1980).

Noall sustained enforcement of an IRS summons to the taxpayer seeking confidential audit reports and related workpapers internally prepared by an employee of the taxpayer, and did not involve consideration of production of tax accrual workpapers or of the constraints upon the independent auditing process inherent in the routine disclosure of such documents.

The First Circuit's decision in *United States* v. *Arthur Andersen & Co.*, *supra*, is likewise not inconsistent with *Coopers & Lybrand*; indeed, the present issue remains open in that circuit. There, Andersen's appeal was dismissed as moot because the firm had produced the summoned tax accrual workpapers for IRS examination rather than stand in contempt of the district court's order. The First Circuit further rejected the appeal by the taxpayer on the ground that the same issue was "so significant" that a case where the documents had already been produced was "in a poor posture to serve as the matrix for a precedent." *United States* v. *Arthur Andersen & Co.*, 623 F.2d 725, 729 (1st Cir. 1980).

The relevance required to support enforcement of an IRS summons should thus properly vary in accordance with the nature of the records or material sought, the party from whom disclosure is demanded, and the Service's ability to particularize a true need for the information sought in order to fulfill its duty of determining the correctness of the return in question. *See* Caplin, *Reflections On I.R.S. Criminal Tax Investigations of Corporations*, 12 CUM. L. REV. 233, 254 (1982) [hereinafter Caplin, *Reflections*]; Comment, *The Creation of an Accountant Workproduct Privilege—Rendering Relevancy Irrelevant*, 57 ST. JOHN'S L. REV. 348, 363 (1983) [hereinafter *Rendering Relevancy Irrelevant*]; Note, *A Balancing Approach to the Discoverability of Accountant's Tax Liability Workpapers Under Section 7602 of the Internal Revenue Code*, 60 WASH. U.L.Q. 185, 203 (1982) [hereinafter *A Balancing Approach*].

5. Balancing the IRS' Need for the Documents Sought Against the Hardship that their Production Would Cause to Third Parties Is Supported by Civil Discovery Cases.

None of this is to say that the IRS is never to gain access to factual information from third parties or is not to perform audits. Upon an appropriate showing, such as, for example, that transactional documents belonging to the taxpayer have been lost or destroyed, balancing the hardship to the IRS and to the third party may result in production of factual portions of tax accrual documents to the IRS. *See, e.g., In re Co-Build Companies*, 77-2 U.S. Tax Cas. (CCH) ¶ 9735 (E.D. Pa. 1977) (taxpayer's internal records destroyed by fire; accountant's records were only available source of information).[9]

9 The record developed below is devoid of any showing by the IRS that it cannot obtain from Hess whatever unspecified transactional information it seeks. Indeed, the district court relied conclusively on the IRS case manager's claim that the tax accrual workpapers would reveal, not transactional information to which the Service is entitled, but "the specific items of questionable deductibility that the taxpayer *possibly* claimed for the relevant tax years." (A. 78) (Emphasis supplied.) *See* 496 F. Supp. at 1156.

The record contains no assertions that the IRS will obtain any factual information as to the deducted items themselves or evidence that Hess acted fraudulently in deducting the items. Rather, the record makes clear that the

Such balancing has its appropriate analogue in cases involving the proper scope of discovery under Rule 26 of the Federal Rules of Civil Procedure. *Upjohn Co.* v. *United States*, 449 U.S. 383, 397-402 (1981). In that context, federal courts regularly weigh the balance of need and hardship. *See, e.g., Centurion Industries, Inc.* v. *Warren Steurer & Associates*, 665 F.2d 323 (10th Cir. 1981) (discovery of confidential business information); *Covey Oil Co.* v. *Continental Co.*, 340 F.2d 993 (10th Cir.), *cert. denied*, 380 U.S. 964 (1965) (same); *Lincoln American Corp.* v. *Bryden*, 375 F. Supp. 109, 112 (D. Kan. 1973) (When "it appears that confidential relationships or established principles of public policy might be unnecessarily compromised. . .such protective power may be used to strike a fair balance of competing interests. . . .") (citations omitted); *Carlson Companies* v. *Sperry & Hutchinson Co.*, 374 F. Supp. 1080, 1088 (D. Minn. 1974) ("[W]hen [discovery] requests approach the outer bounds of relevance. . .the Court must then weigh that request with the hardship to the party from whom the discovery is sought.").[10]

The flexible balancing test advocated here also comports with and is supported by this Court's decision in *Upjohn Co.* v. *United States*, 449 U.S. 383 (1981), applying the work product doctrine to Section 7602(a). This Court emphasized the "strong public policy" which protects against compelled disclosure of the " 'mental impressions, conclusions, opinions

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IRS seeks not additional facts as to specific transactions, but rather a convenient roadmap through the tax accrual workpapers to discover the opinions of Hess' management and Arthur Young as to those items whose deductibility might be questioned by the IRS and speculation by Arthur Young as to the probable resolution of any such items. This, as made clear above, provides no basis for the proper enforcement of a summons and does not outweigh the prejudice to the audit process caused by the production of these workpapers.

10 *See also Carr* v. *Monroe Mfg. Co.*, 431 F.2d 384 (5th Cir. 1970), *cert. denied*, 400 U.S. 1000 (1971); *Mitchell* v. *Bass*, 252 F.2d 513 (8th Cir. 1958); *Doe* v. *United States Civil Serv. Comm.*, 483 F. Supp. 539, 579 (S.D.N.Y. 1980).

or legal theories of an attorney or other representative of a party concerning litigation' " to the IRS. *Id.* at 400, *quoting* Rule 26 of the Federal Rules of Civil Procedure. *See United States* v. *Nobles*, 422 U.S. 225, 236-40 (1975). The Court therefore denied enforcement of the IRS summons which sought production of the results of an internal corporate counsel's investigation as to potentially corrupt payments, ruling that "a far stronger showing of necessity and unavailability by other means than was made by the Government. . . in this case would be necessary to compel disclosure." *Upjohn Co.*, 449 U.S. at 402.

Although the Institute does not contend that *Upjohn* is directly on point, it is nonetheless submitted that, particularly when read in light of *Hickman* and *Nobles*, this Court in *Upjohn* espoused a policy which strongly favors "protecting the taxpayer's expectation of confidentiality and establishing a regimen of fair play between Government and taxpayer." Caplin, *Reflections*, *supra*, at 256; *see also A Balancing Approach*, *supra*, at 206-07.

The balancing approach has an additional analogue in the limitations on discovery permitted in the United States Tax Court. *See, e.g., P.T. & L. Construction Co.* v. *Commissioner*, 63 T.C. 404, 414 (1974) ("[W]hat is relevant is the *factual information*. . . .Mental impressions, legal analysis, conclusions, and recommendations are generally not relevant.") (emphasis in original); *Esson* v. *Commissioner*, 34 T.C.M. (CCH) 586, 587 (1975) (same).

Moreover, in a significant and analogous trend, a growing number of lower federal court decisions have applied this balancing approach to shield critical self-evaluation reports prepared by institutions and individuals from discovery under Rule 26(c), when protection of confidentiality of their contents is required on public policy grounds to encourage the free flow of information. For example, discovery has been disallowed, on balance, with respect to college faculty evaluation reports in order to enable the institution to obtain honest and candid peer review of faculty professors. *Keyes* v. *Lenoir Rhyne College*,

552 F.2d 579, 581 (4th Cir.), *cert. denied*, 434 U.S. 904 (1977).[11] A widely recognized self-critical analysis discovery privilege has thus emerged under federal law that would conditionally shield tax accrual workpapers from discovery under Rule 26(c). Note, *The Privilege of Self-Critical Analysis*, 96 HARV. L. REV. 1083, 1095 n.40 (1983).

C. Enforcement of the Summons Issued Here Violates the Spirit of Internal IRS Guidelines.

The relevancy standard urged here is also supported by internal IRS guidelines, procedures, and pronouncements and any less flexible standard would contradict those internal rules.[12]

Because tax accrual workpapers contain not only the sensitive opinions, conjectures, and speculations received by independent certified public accountants from their clients' personnel, but also those put forward by the auditors themselves, the Institute did not contemplate, when it promulgated its Statements on Auditing Standards, that workpapers prepared pursuant thereto would be routinely available to the IRS for the mere asking. Indeed, the Institute's Federal Taxation Division believed, from discussions with the IRS extending over many years, that the IRS comprehended the importance to the audit process of maintaining the confidentiality of such

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11 *See, e.g.*, *EEOC* v. *University of Notre Dame Du Lac*, DAILY LAB. REP (BNA) No. 166, at D-1 (7th Cir. Aug. 17, 1983); *Emerson Elec. Co.* v. *Schlesinger*, 609 F.2d 898 (8th Cir. 1979); *Reynolds Metals Co.* v. *Rumsfeld*, 564 F.2d 663 (4th Cir. 1977), *cert. denied*, 435 U.S. 995 (1978); *Webb* v. *Westinghouse Elec. Corp.*, 81 F.R.D. 431 (E.D. Pa. 1978); *Bredice* v. *Doctors Hosp., Inc.*, 50 F.R.D. 249 (D.D.C. 1970), *aff'd mem.*, 479 F.2d 920 (D.C. Cir. 1973).

12 While Examination Division guidelines do not apply in joint investigation cases, such as the present one, 1 INTERNAL REVENUE MANUAL (CCH) (AUDIT) ¶ 4024.1 (1981), the court below treated the summons issued in this case effectively as one issued in aid of a civil audit. *See* 677 F.2d at 218. However, it is significant to note that the Examination Division guidelines discussed below were promulgated after the issuance of the summons in this case, and thus are not directly applicable here. They do, however, reflect the Service's own appreciation of the standards governing third-party access and, hence, are instructive.

client information and that the IRS had therefore tacitly agreed to limit its efforts to obtain access to tax accrual workpapers to extraordinary cases.

The IRS Handbook for Special Agents was accordingly amended in 1977 to provide, in pertinent part:

> The inquiry cannot amount to an inquisition or arbitrary inquiry on the part of the tax investigators. A reasonable basis for making the inquiry must exist. What is justifiable "fishing" will be determined from all the facts in each case including the end for which the information is sought. *The investigation must not be an unreasonable burden on the third party whose records are sought.*
>
> In a fraud case, a test as to whether the examination would impose an unreasonable burden is whether the facts show *a reasonable ground of suspicion or probable cause for the examination to ascertain if there has been a fraud*. The burden upon the third party must be considered in relation to the expected degree of success in finding documents bearing upon the tax liability of the taxpayer being investigated.

IRS Manual MT 9900-36 §§ 267.2(5) and 267.51(2) (March 1, 1977) (emphasis supplied) (footnotes omitted).

And with respect to the workpapers of an independent auditor, the IRS issued guidelines requiring the examiner to remember that "the taxpayer's records are the primary source of information and the accountant's workpapers should normally be used only as a collateral source, access to which should be requested with discretion." 1 INTERNAL REVENUE MANUAL (CCH) (AUDIT) ¶ 4024.2(2) (1980). *See also* IRS Information Notice 80-7 (August 4, 1980). More significantly, the director of the IRS Examination Division unqualifiedly directed that opinions or judgments contained in tax accrual workpapers are not relevant to an IRS examination:

> The examiner's interest in the "items" that make up the tax accrual does not include the independent accountant's or taxpayer's opinion of the value of the issues or the

> likelihood of success in litigation, but rather an identification of the undisclosed position taken by the taxpayer.

Id. It is questionable whether opinion can be separated from underlying fact in order that this directive be carried out.

On May 14, 1981 the Service again revised the guidelines, apparently in response to adverse corporate taxpayer reaction to the June 1980 directives. This reaction in part took the form of a palpable reluctance on the part of some corporate taxpayers to cooperate fully with independent auditors due to a perception that the IRS had taken insufficient measures to restrict examining agents' access to confidential accrual workpapers. *See, e.g.*, Buchholz, *Tax Accrual File Controversy: Legal Problems Facing the Accountant*, 40th ANN. N.Y.U. INST. ON FED. TAX'N § 37.04[2] (1982) [hereinafter Buchholz]. Accordingly, the revised guidelines tightened existing restrictions even further, preliminarily establishing a firm policy that tax accrual workpapers should be requested only under "unusual circumstances." I INTERNAL REVENUE MANUAL (CCH) (AUDIT) ¶ 4024.4(1) (1981).

In addition to the various foregoing strictures, examiners are now expressly precluded from requesting accrual workpapers unless the taxpayer audit has been substantially completed, specific issues have been identified, and it is determined that additional facts are needed. *Id.* ¶ 4024.4(2). The new directives not only require the agent to exhaust efforts to obtain the necessary factual information from the taxpayer, but also mandate that he request that the auditor provide a separate analysis (but not necessarily contained in the workpapers) relating to those identifications of the facts prior to seeking access to the auditor's tax accrual workpapers. *Id.* Finally, summonses for these workpapers may not be issued until the agent has reconciled book income to taxable income (Schedule M1), *id.* ¶ 4024.4(4), and obtained the prior written approval of the Chief of the Examination Division. *Id.* ¶ 4024.4(5).

In this case, the IRS has disregarded the spirit of its own general guidelines concerning the limited circumstances under which efforts to obtain auditors' workpapers should be implemented, and has made no attempt to cull the facts it needs to

complete its audit from available sources other than the tax accrual workpapers. The Service's guidelines represent a thoughtful analysis of the proper balance to be attained between the IRS' need for access to information and auditors' need for full and complete disclosure by clients. The Institute submits that the principles expressed in these guidelines should be considered by the Court in determining the scope of disclosure actually required to satisfy the Service's legitimate needs.

POINT II

SUBSTANTIAL POLICY CONSIDERATIONS INVOLVING THE PROFESSIONAL RESPONSIBILITIES OF AUDITORS AND THE NEEDS OF INVESTORS FOR FULL AND FAIR DISCLOSURE IN FINANCIAL STATEMENTS FAR OUTWEIGH THE CONVENIENCE OF ACCESS BY THE SERVICE TO TAX ACCRUAL WORKPAPERS IN THE HANDS OF PARTIES OTHER THAN THE TAXPAYER.

Implicit in the argument as presented thus far is the Institute's firm belief that public policy issues important to both the accounting and auditing profession and to the investing public are enmeshed within the fabric of this appeal. This case does not reach the Court in a simple context arraying private contestants on one side against the IRS as the sole guardian of the public interest on the other. Quite to the contrary, there is at issue here, as the Second Circuit properly elucidated below, a direct clash of public policies which requires recognititon and ultimate resolution by this Court.

Tax accrual workpapers reflect communications made to the independent auditor pursuant to an historically based and traditionally recognized cloak of confidentiality.[13] The record in this case, together with the wealth of scholarly and profes-

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13 This expectation of confidentiality is embodied, for example, in the various ethical codes governing the conduct of the independent public accounting and auditing profession promulgated by the Boards of Accountancy of all fifty states and the District of Columbia.

sional commentary that the dispute in question has generated since the mid-1970's, demonstrate that unlimited revelation of the audit client's comments and conjecture to the Internal Revenue Service's agents will unnecessarily inhibit the open and candid exchange between auditor and client essential to the effectiveness of the independent audit process mandated by the Securities Laws.[14] The auditor's ability to obtain the informa-

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14 *See* quotation from record at p. 7, *supra*. For discussions of the specific policy concern that routine IRS discovery of tax accrual workpapers will substantially impede the flow of accurate financial information from the corporate taxpayer to the independent auditor, *see* IRS ACCESS TO ACCOUNTANTS' WORKPAPERS 53-54, 199 (N.Y.L.J. Law Journal Seminars—Press 1980); Buchholz, *supra*, at § 37.06; Caplin, *IRS Toughens Its Stance on Summoning Accountant's Tax Accrual Workpapers*, 53 J. TAX'N 130, 130 (1980); Caplin, *Reflections*, *supra*, at 246-47, 260; Caplin, *Tax Accrual Workpapers*, *supra*, at 199; Garbis & Struntz, *The Second Circuit's Arthur Young Decision: A Privilege for Tax Accrual Workpapers*, 57 J. TAX'N 66, 67 (1982); Hanson & Brown, *CPA's Workpapers: The IRS Zeroes In*, 152 J. ACCT. 68, 70, 71, 76 (1981); Horvitz & Hainkel, *The IRS Summons Power and Its Effect* [sic] *on the Independent Auditor*, 4 J. ACCT., AUD. & FIN. 114, 127 (1981); Robinson & Stoltenberg, *Privilege and Accountants' Workpapers*, 68 A.B.A.J. 1248, 1249 (1982); Stoltenberg & Robinson, *Enforcement of Summonses in Requesting Accountants' Workpapers*, 60 TAXES 673, 675 (1982); Sumner & Reed, *New IRS Guidelines Are Accountants' Best Hope for Protecting Tax Accrual Workpapers*, 27 TAX'N ACCT. 72, 72-73 (1981); *Rendering Relevancy Irrelevant*, *supra*, at 359-61; Note, *Auditor-Client Work-Product Privilege With Respect to Tax Accrual File: The Arthur Young Case*, 27 ST. LOUIS U.L.J. 437, 439-43 (1983); *A Balancing Approach*, *supra*, at 190, 206-207; Note, *Government Access to Corporate Documents and Auditors' Workpapers: Shall We Include Auditors Among the Privileged Few?*, 2 J. CORP. L. 349, 382-88 (1977); *IRS Access to Tax Accrual Workpapers*, *supra*, at 481-84.

For other general discussions of the tax accrual workpapers controversy, *see* Andrews, *Internal Revenue Service Subpoena Power and Audit Workpapers*, 31 OIL & GAS TAX Q. 440 (1982); Diss & Hanson, *Tax Contingency Audit Workpapers: 1981-1982 Developments, Observations and Proposals*, 14 TAX ADVISER 154 (1983); Diss & Hanson, *Tax Contingency Audit Workpapers: Current Developments, Observations and Proposals*, 12 TAX ADVISER 104 (1981); Fink, *Internal Revenue Summons Power*, 38th ANN. N.Y.U. INST. ON FED. TAX'N ch. 19, 19-6 to 19-10 (1980); Kurtz, *Discussion on "Questionable Positions"*, 32 TAX LAW. 13 (1980); Nath, *Internal Revenue Service Summonses for "Sensitive" Accountants' Papers*, 34 VAND. L. REV. 1561 (1981); Saltzman, *Accountants and the IRS Summons: Recent Develop-*

tion needed to formulate an opinion with respect to the adequacy of the client's accrued tax liability will thus be fundamentally impeded. The resulting effect upon the reliability of the audit process is obvious, as is the identity of the group that will suffer the ultimate harm emanating from this scenario—the investing public.

A. The Breadth of the IRS Summons Power is Appropriately Circumscribed by Strong Countervailing Public Policy Considerations.

While this Court has often emphasized the duty of every citizen to appear and give testimony or produce records when properly summoned by competent authority, *see, e.g.*, *Blackmer* v. *United States*, 284 U.S. 421, 438 (1932); *Blair* v. *United States*, 250 U.S. 273, 281 (1919), it has also recognized the virtue in excusing the performance of this civic duty when an "exemption is grounded in a substantial individual interest which has been found . . . to outweigh the public interest in the search for truth." *United States* v. *Bryan*, 339 U.S. 323, 331 (1950).

The Congressional grant of summons authority to the IRS may indeed be substantial, but that power is no broader than the traditional subpoena authority addressed in *Bryan* and has in fact been characterized as a "limited power." *United States* v. *Bisceglia*, 420 U.S. at 151. Accordingly, the obligation to respond thereto, it is well established, remains subject to the corollary principle, traceable to a 1911 interpretation by this Court, that revenue enforcement provisions must yield when necessary for the protection of more significant concerns. *United States* v. *Chamberlin*, 219 U.S. 250, 269 (1911).

This Court has recently confirmed that the summons power of the IRS is not only subject to appropriate assertions of traditional evidentiary privileges, such as the attorney-client privilege and work product rule, *Upjohn Co.* v. *United States*,

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ments, 7 TAX ADVISER 516 (1976); Saltzman, *What an Accountant Can Do About the Threat of an IRS Summons to Produce His Workpapers*, 17 TAXN ACCT. 208 (1976).

supra, but also that "the claimed enforcement authority of the Service . . . [may be] undercut by contrary legislative purposes." *United States* v. *Euge*, 444 U.S. at 715-16. In upholding the Service's right to compel production of handwriting exemplars from a taxpayer, the Court in *Euge* did not rely solely upon the language of Section 7602(a), nor even upon its own interpretation of the statute. Rather, this Court articulated a balancing test which weighed the necessity of obtaining the handwriting exemplar from the taxpayer against competing "constitutional rights *or countervailing policies enunciated by Congress*." *Id.* at 711 (emphasis supplied).[15]

B. Maintenance of the Reliability of the Audit Process and the Protection of the Investing Public Require that Independently Prepared Tax Accrual Workpapers be Conditionally Immunized from Compelled Disclosure.

The present case poses the very clash between countervailing Congressional policies anticipated but not resolved in *Euge*. These significant policy considerations preclude judicial enforcement of IRS summonses demanding production of independent auditors' tax accrual workpapers. Congress has entrusted to the private sector in the first instance achievement of the public policy of full and fair disclosure explicit in the Securities Laws. Independent auditors, by auditing the financial statements of public companies and informing the investing public through their opinions on these companies' published financial statements, play a central role in attaining

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15 Petitioner cites this Court's decision in *St. Regis Paper Co.* v. *United States*, 368 U.S. 208 (1961), in support of its position that an express mandate of confidentiality in the Securities Laws is a necessary prerequisite to any conditional protection of tax accrual workpapers from general IRS disclosure. That case, however, presented no significant policy issue concerning the protection of a professional relationship from outside incursion in order to maintain the quality of continued compliance with federal reporting and disclosure laws. Thus, *St. Regis* is distinguishable. Moreover, no such limitation on the protection of sensitive information from IRS discovery is to be found in *Euge*, which is this Court's most recent pronouncement with respect to the precise issue here—the scope of the IRS summons power.

that goal. Their opinion, rendered after an examination made in compliance with GAAS, expresses a judgment as to the fair presentation of the financial statements in accordance with generally accepted accounting principles, and is a necessary condition to—indeed, an integral part of—the issuance of a registration statement under the Securities Act of 1933 and the annual filing requirements of the Securities Exchange Act of 1934. Regulation S-X, 17 C.F.R. § 210.1-01 *et seq*.

This role is the result of an elaborate framework developed by the SEC, the Institute and others over time. It contemplates an extensive interaction between the independent auditor and the public company with the dual goals of full and fair disclosure as mandated by the Securities Laws and the promotion of the integrity and objectivity of financial statements.

The interaction between the SEC and the audit profession, developed over time to provide the disclosure needed to effectuate the intent and directives of the Securities Laws and the protection of investors, is jeopardized by forced disclosure of tax accrual workpapers absent a demonstration of a particularized need. It was the perceived need to protect and enhance this interaction that motivated the Second Circuit to deny enforcement of the summons below. 677 F.2d at 219-20.

Similarly, it is the interaction between SEC and auditor and the unique role of the *independent* auditor in the audit process that provides the fundamental and determinative distinction between this case and the decisions in *El Paso*, which required production of internally prepared tax accrual workpapers, and in *Noall*, which involved production of internal auditors' workpapers.[16] The internal auditor is assigned no express role

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16 To the extent the reasoning expressed in *El Paso* could be considered applicable to the independently prepared accrual workpapers at issue here, despite the fundamentally different functions undertaken by independent and internal auditors, the decision in *El Paso* is premised upon a highly suspect analysis. The Fifth Circuit rejected the public policy argument presented here, and adopted by the Second Circuit below, essentially because it believed that the threat of SEC prosecution for violation of the Securities Laws sufficiently dissuaded corporate taxpayers from withholding informa-

in this interaction under the Securities Laws and, moreover, lacks the independence required of an independent auditor to render an opinion in conformity with GAAS. Regulation S-X, *supra*, at § 210.2-01. Internal audit reports are not relied on by the general investing community, whereas independent auditors provide the means through which the private sector fulfills its assigned duty of affording an independent review of financial statements and reports thereon to the general investing community. To perform that function, independent auditors need full and confidential communication with their clients in order to form a judgment as to the adequacy of the accrual for unpaid taxes and render the requisite opinion with respect to the fairness of the financial statements.

By emphasizing the policy concerns that are necessarily raised by any interference with the auditor-client relationship through routine compelled disclosure of tax accrual workpapers to the IRS, the Institute does not mean to suggest that wholesale violation of the reporting requirements of the Securities Laws will eventuate if the position for which Petitioner contends is adopted. Rather, the Institute believes that the chilling effect of such routine disclosure will result in growing reluctance on the part of corporate taxpayers to record candid and thorough accrued tax liability analyses and also to share those analyses with independent auditors. Thus, once it becomes clear that the IRS has an unconditional right to examine

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tion from, and not cooperating with, independent auditors. 682 F.2d at 544. This reasoning is fundamentally at odds with the rationale posed by this Court in *Upjohn* in its refusal to narrow the scope of the attorney-client privilege on the similar ground that corporations facing the risk of criminal liability have an adequate incentive to investigate possible internal wrongdoing even without the protective shield of that privilege. This Court concisely disposed of the contention by noting that the argument "ignores the fact that the depth and quality of any investigations to ensure compliance with the law would suffer, even if they were undertaken." 449 U.S. at 393 n.2. The precise concern identified in *Upjohn* is entirely applicable here, for it is undeniable that regardless of any fear of SEC prosecution, the "depth and quality" of the independent auditor's evaluation of the accuracy of the client's contingency tax reserve will be diminished if these accrual workpapers are subject to routine IRS examination.

the workpapers, corporations and their tax advisers will understandably strive to disclose as little as possible in their written accrued tax liability analyses and supporting documentation, and will be inhibited in discussing anticipated tax litigation. *See* Buchholz, *supra*, at § 37.06; *A Balancing Approach*, *supra*, at 206-207; *IRS Access to Tax Accrual Workpapers*, *supra*, at 483-84; *cf. Hickman* v. *Taylor*, 329 U.S. 495, 511 (1947) ("much of what is now put down in writing would remain unwritten").

Indeed, as the Petitioner's brief makes abundantly clear, a public corporate taxpayer is under a legal duty to submit adequate audited financial statements to the SEC, and penalties for inadequacies provide an incentive to ensure minimum compliance with those reporting and disclosure requirements. Moreover, the auditor is under a professional duty to take exception to materially false or misleading financial statements and to qualify his opinion if inadequate documentation of transactions raises questions in his mind regarding the adequacy of tax accruals in those financial statements. The increasing tension between auditor and client that has developed as a result of the interplay between these conflicting interests and IRS access to tax accrual workpapers was the subject of an auditing interpretation issued by the Institute in March, 1981, which details some of the very troubling informational barriers imposed upon the auditing profession since the tax accrual workpapers controversy first arose. AICPA Auditing Interpretation, *The Effect of an Inability to Obtain Evidential Matter Relating to Income Tax Accruals*, 1 AICPA PROF. STAND. (CCH) AU § 9326.06-.17 (1982).

Thus, while various existing legal incentives should ensure continued minimum compliance even in the absence of some conditional immunity from IRS summons power for tax accrual workpapers, it is evident from what has been said so far that both the "depth and quality" of the independent auditor's tax accrual analysis will be impeded and gradually eroded if these workpapers are subject to IRS disclosure in the normal course of every corporate tax audit. See *Upjohn Co.* v. *United States*, 499 U.S. at 392 n.2. Although corporate taxpayers

would initially prepare and provide auditors with minimal information about tax accruals made by the taxpayer in order to obtain an unqualified opinion, the absolute discoverability rule urged by Petitioner will, over time, infect and eventually impair the reliability of the provision for accruals for unpaid taxes reflected in financial statements and make it increasingly difficult for auditors to fulfill their professional duty, in the public interest, of examining and testing the adequacy of those accruals.

Such a result is unacceptable; fortunately, it is also unnecessary. The flexible balancing test proposed by the Institute accommodates all of the various interests involved. The IRS would be entitled to access to specified portions of tax accrual workpapers prepared by independent auditors if and when it was able to make a demonstration of a particularized and identifiable need. At the same time, corporate taxpayers would not be disposed to limit disclosure to auditors to the bare minimum needed to ensure compliance with the Securities Laws, and auditors would simultaneously be able to rely on this uninhibited disclosure in rendering unqualified opinions and would thereby avoid being placed in what is in effect an adversarial relationship with their own clients. There thus exists an accommodating alternative to the absolute disclosure rule proposed by Petitioner which can resolve the tension between the discovery provisions of the revenue laws and the reporting provisions of the Securities Laws in a manner respectful of the policies underlying each.

In this case, and on this record, the utility of the independent audit in the capital formation process and the public policies expressed by the Securities Laws far outweigh the convenience of the Service. Absent a particularized demonstration that the IRS cannot conduct an effective and thorough audit of a corporate tax return without access to the sensitive and confidential information contained in tax accrual workpapers prepared by the independent auditors, this Court should not permit the indiscriminate use of the summons power exhibited in this case.

CONCLUSION

The order of the Court of Appeals for the Second Circuit should be affirmed.

Respectfully submitted,

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APPENDIX

Section 7602(a) of the Internal Revenue Code provides in its entirety as follows:

> AUTHORITY TO SUMMON, ETC.—For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax, or collecting any such liability, the Secretary or his delegate is authorized—
>
> (1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry;
>
> (2) To summon the person liable for tax or required to perform the act, or any officer or employee of such person, or any person having possession, custody, or care of books of account containing entries relating to the business of the person liable for tax or required to perform the act, or any other person the Secretary or his delegate may deem proper, to appear before the Secretary or his delegate at a time and place named in the summons and to produce such books, papers, records, or other data, and to give such testimony, under oath, as may be relevant or material to such inquiry; and
>
> (3) To take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry.

No. 82-687

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

UNITED STATES OF AMERICA, *Petitioner,*

—v.—

ARTHUR YOUNG & COMPANY

—and—

AMERADA HESS CORPORATION, *Respondents.*

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF *AMICI CURIAE* OF ARTHUR ANDERSEN & CO., ALEXANDER GRANT & COMPANY, COOPERS & LYBRAND, DELOITTE HASKINS & SELLS, ERNST & WHINNEY, PEAT, MARWICK, MITCHELL & CO., PRICE WATERHOUSE, SEIDMAN & SEIDMAN AND TOUCHE ROSS & COMPANY IN SUPPORT OF RESPONDENTS

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INTEREST OF *AMICI CURIAE*

This brief in support of respondents is submitted, with the consent of all parties, on behalf of Arthur Andersen & Co., Alexander Grant & Company, Coopers & Lybrand, Deloitte Haskins & Sells, Ernst & Whinney, Peat, Marwick, Mitchell & Co., Price Waterhouse, Seidman & Seidman and Touche Ross & Co. as *amici curiae*.

The *amici curiae* are firms engaged in the practice of the profession of accounting. They perform the same audit function as is performed by respondent Arthur Young & Company. They share with that firm the concern that their audit clients not be inhibited in communicating to them the clients' thinking concerning tax liability and strategy for the resolution of tax disputes.

The *amici curiae* believe that a brief presentation of their analysis of the issue can assist the Court in its consideration of whether auditors' tax accrual workpapers should be protected by a qualified privilege when production of the workpapers is sought by a summons under I.R.C. § 7602.

SUMMARY OF ARGUMENT

The court of appeals protected tax accrual workpapers from IRS discovery because discovery of taxpayer thinking and an auditor's evaluation of its client's tax liability would tend to compromise the procedure designed by Congress to protect the investing public from inaccurate financial information and is not needed by the IRS, which has access to the transactional data. Since the protection is a qualified privilege against discovery of thoughts and conclusions, not evidence, it does not create a client-accountant privilege for transactional data or contradict the principle that the public has a right to every man's evidence. It does, however, properly reject "considerations of [IRS] convenience." *Upjohn* v. *United States*, 449 U.S. 383, 396 (1981).

The qualified privilege fashioned by the court carries out the "general mandate" of Rule 501 of the Federal Rules of Evidence that the courts "continue the evolutionary development of . . . the law of privilege." *Trammel* v. *United States*, 445 U.S. 40, 47 (1980). It accords with "reason and experience." Fed. R. Evid. 501.

The Section 7602 summons provides the occasion for, but not the answer to, the question of whether tax accrual workpapers should be protected by a qualified privilege. Enforcement

of Section 7602 is limited by privilege, including such a qualified privilege as that of *Hickman* v. *Taylor*, 329 U.S. 495 (1947), for the thinking of an attorney. *Upjohn Co.* v. *United States*, *supra*.

The qualified privilege obviates the substantial constitutional question that would be presented if self-questioning by the taxpayer were added to the self-reporting tax system by way of IRS discovery of tax accrual workpapers. Unfairness as between Government and taxpayer and governmental prying into private thought implicate the Bill of Rights. *Cf. First National Bank* v. *Bellotti*, 435 U.S. 765 (1978).

ARGUMENT

TAX ACCRUAL WORKPAPERS SHOULD BE PROTECTED FROM SECTION 7602 DISCOVERY BY A QUALIFIED PRIVILEGE

The court of appeals protected tax accrual workpapers from discovery by the IRS because:

> — the auditor's inquiry of its client, which is recorded in the tax accrual workpapers, "lays bare" the "basic thinking" of the client as a taxpayer, including settlement positions and strategy;
>
> — the prejudice to the client of permitting IRS discovery of the client's thinking as recorded in the workpapers is such that "a prudent organization might not be perfectly candid with independent auditors";
>
> — such an inhibition upon client candor "compromises the procedure designed by Congress to protect the investing public from inaccurate financial information";
>
> — absent allegations of fraud, the IRS "does not need to know [a] taxpayer's thoughts"; and
>
> — the "corporation's own books and the audit workpapers furnish the IRS with all the raw data that it needs to calculate the taxpayer's tax liability." (677 F.2d at 220.)

The Court also noted the proposal of former Commissioner Kurtz that "taxpayers flag their questionable positions directly on their returns . . . ." (677 F.2d at 221), but said that "[p]rocuring tax accrual workpapers under Section 7602 seems to us to effectuate Commissioner Kurtz' proposals through the back door." (677 F.2d at 221.)

Congress has chosen a different approach—an approach that does not intrude upon the candid communication between client and auditor that is essential to the audit function. In I.R.C. § 6661, which was enacted after the decision below, Congress provided for a surcharge of 10% of the underpayment attributable to a substantial understatement of tax due unless (tax shelters aside) there is substantial authority for the taxpayer's treatment of any item or the relevant facts are adequately disclosed by the taxpayer. Congress thus left disclosure of the tax treatment of particular items to the taxpayer (not the auditor) with the impetus of a possible surcharge.

As ultimately recognized by the Government at page 35 of its brief, the court of appeals "focused on fostering candid communications from client to accountant." The court did so to protect the disclosure process mandated by the federal securities laws, while also providing to the IRS the evidence needed by it to determine the correctness of the client's tax return.

The court likened its protection of the tax accrual workpapers to the work-product privilege fashioned in *Hickman* v. *Taylor, supra*. As with that privilege, the protection accorded the tax accrual workpapers is qualified. It may be overridden by a sufficient showing of need (677 F.2d at 221)—but when the case does not involve allegations of fraud, the convenience to the IRS of "a roadmap of the thoughts and theories of a taxpayer and its independent auditor" does not suffice. (Id. at 220.)

As in *Hickman*, the protection of the tax accrual workpapers is not a testimonial privilege, but a discovery privilege.[1] It

---

1 It follows from protection of the tax accrual workpapers that the IRS may not obtain access to the same subjective thoughts by summoning the testimony of the auditor who created the workpapers.

protects a subjective "roadmap." It does not deprive the IRS of the evidence upon which to base or compromise a claim of tax liability.

Protection of tax accrual workpapers does not create an absolute "accountant-client privilege" such as was referred to in *Couch* v. *United States*, 409 U.S. 322, 335 (1973), where the issue was not protection of the thinking of the taxpayer but rather production of the taxpayer's "bank statements, payroll records, and reports of sales and expenditures" which the taxpayer had given to her accountant. (409 U.S. at 324.) Since the qualified privilege protects thoughts, not evidence, it does not contradict the principle that " 'the public . . . has a right to every man's evidence.' " *Trammel* v. *United States*, *supra*, 445 U.S. at 50 (1980). These are the straw men of the Government's argument: *Couch* is cited nine times (Gov't Br. 5, 9, 11, 14, 28, 32, 35, 36, 38).

It is the convenience of the IRS, not evidence needed to ascertain the correctness of tax returns, which is at the heart of the Government's argument. Protection of tax accrual workpapers properly rejects "considerations of convenience." *Upjohn Co.* v. *United States*, *supra*, 449 U.S. at 396.

A. The Privilege Carries Out the Mandate of Rule 501

Rule 501 of the Federal Rules of Evidence is a "general mandate" to the courts "to continue the evolutionary development of . . . the law of privilege." *Trammel* v. *United States*, *supra*, 445 U.S. at 47. "[T]he recognition of a privilege based on a confidential relationship and other privileges should be determined on a case-by-case basis." S. Rep. No. 1277, 93d Cong., 2d Sess. 13 (1974), *reprinted in* 1974 U.S. Code Cong. & Ad. News 7051, 7059.[2]

As the rule provides, the courts are to carry out this mandate "in the light of reason and experience." *Id.* at 11, 1974 U.S.

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2 *Couch* was decided before the adoption of Rule 501 of the Federal Rules of Evidence.

Code Cong. & Ad. News at 7058. "[A] federally developed common law based on modern reason and experience shall apply. . . ." *Id.*

The privileges contemplated by the rule extend to persons and situations beyond the testimony of a witness. "The words 'person, government, State, or political subdivision thereof' were added by the Committee to the lone term 'witnesses' used in Rule 26 [of the Federal Rules of Criminal Procedure] to make clear that, as under present law, not only witnesses may have privileges." H.R. Rep. No. 650, 93d Cong., 1st Sess. 8-9 (1973), *reprinted in* 1974 U.S. Code Cong. & Ad. News 7075, 7082.

The protection fashioned by the court of appeals for tax accrual workpapers protects a "person"—the independent auditor—against discovery of its recording of its own evaluations and the tax thinking—not the transactional data—of its client. Workpapers reflecting the audit of underlying transactions, in contrast to the auditor's assessment of the adequacy of the tax reserve, are not protected by the ruling of the court of appeals.

The protection of thinking accords with reason and experience. It recognizes that permitting discovery by the IRS of the client's thinking may lessen the candor with which the client communicates with the independent auditor and thus compromise the effectiveness of the audit function performed by independent accountants as is required by the federal securities laws.[3] The IRS has access to the client's transactional data. The qualified nature of the privilege responds to the needs of the IRS, but not to its convenience.

B. Enforcement of a Section 7602 Summons is Limited by Privilege

Without Section 7602, there would be no authority for discovery by the IRS of any of the workpapers of an indepen-

3 The importance of client candor and audited financial statements is not restricted to the financial statements called for by federal law.

dent auditor. The statute provides the occasion for, but not the answer to, the question of whether tax accrual workpapers should be accorded the protection of a qualified privilege.

Section 7602 does not provide the "complete latitude to the summons power that the IRS seeks here . . . ." (677 F.2d at 220.) Enforcement of a Section 7602 summons is subject to limits, and one such limit is privilege. *United States* v. *Euge*, 444 U.S. 707, 712 (1980).

The privilege need not be ancient or absolute. The protection for the thinking of an attorney which the Court fashioned in *Hickman* v. *Taylor*, *supra*, and upon which the court of appeals patterned its protection for the thinking of a taxpayer is just such a limit upon a Section 7602 summons. *Upjohn Co.* v. *United States*, *supra*.

C. The Privilege Obviates a Substantial Constitutional Question

The qualified privilege for tax accrual workpapers properly weighs the process designed by the federal securities laws to protect investors against materially misleading finanical statements against the convenience of the IRS in examining tax returns. The rights of the taxpayer under a self-reporting tax system figure in a broader equation and support the privilege.

The majority below recognized that "requiring the taxpayer alone to disclose settlement positions would improperly weight the balance [in negotiations between the taxpayer and the IRS]." (677 F.2d at 220.) The dissenting judge noted that whether "sweeping self-questioning" by taxpayers "can or should" be added to the self-reporting tax system is "fairly debatable." (677 F.2d at 224 n.8, Newman, J., dissenting in part.)

The Court has held that to obtain judicial enforcement of a § 7602 summons the IRS "must show," among other things, that its investigation has a legitimate purpose and that the information sought is not already within its possession. *United States* v. *Powell*, 379 U.S. 48, 57-58 (1964). Already having

possession of the taxpayer's transactional data, the IRS cannot make the required showing unless in ascertaining the correctness of the tax returns when fraud is not alleged the IRS is entitled, not only to the facts, but also to the taxpayer's and auditor's thoughts concerning the facts.

To require that, in addition to accurate factual statement and honest judgment, a taxpayer direct the IRS to particular areas of inquiry smacks of unfairness as well as Government prying. Unfairness between the Government and private persons and governmental prying into private thought implicate the Bill of Rights. *Cf. First National Bank* v. *Bellotti, supra.*

• • •

CONCLUSION

The judgment of the court of appeals insofar as it reversed the district court's order that the tax accrual workpapers be produced should be affirmed.

Respectfully submitted,

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

UNITED STATES OF AMERICA,
Petitioner,

v.

ARTHUR YOUNG AND COMPANY, *et al.*,
Respondents.

On Writ of Certiorari to the
United States Court of Appeals for the Second Circuit

BRIEF AMICUS CURIAE OF THE CHAMBER OF COMMERCE OF THE UNITED STATES

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

No. 82-687

UNITED STATES OF AMERICA,
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v.

ARTHUR YOUNG AND COMPANY, *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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BRIEF AMICUS CURIAE OF THE CHAMBER OF COMMERCE OF THE UNITED STATES

INTEREST OF THE AMICUS CURIAE [1]

The Chamber is the largest federation of corporations, trade associations, chambers of commerce and individuals engaged in business and the professions, with an aggregate membership in excess of 209,000.

The Chamber regularly presents its member's views to this Court and the lower federal courts on matters of major concern to the business community.[2] Of particular

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[1] This brief is filed with the written consent of the parties pursuant to Supreme Court Rule 36.1. The Chamber is submitting Petitioner's consent to the clerk. Respondents are sending their consent directly to the Court.

[2] *See Newport News Shipbuilding and Drydock Co.* v. *EEOC*, —— U.S. ——, No. 82-411 (June 20, 1983); *Upjohn Co.* v. *United States*, 449 U.S. 383 (1981); *First National Maintenance Corp.* v. *NLRB*, 449 U.S. 1076 (1981); *Gould Corp.* v. *NLRB*, 612 F.2d 728 (3rd Cir. 1979).

importance here is the Chamber's participation as an *amicus curiae* in support of the *Petition for Certiorari* in *El Paso Company* v. *United States, petition for cert. filed*, 51 U.S.L.W. 3342, (U.S. Oct. 22, 1982) (No. 82-716).

The ultimate issue presented in *El Paso* is identical to that presented here: absent allegations of fraud, can the Internal Revenue Service ("I.R.S.") obtain enforcement of a summons for tax analysis workpapers prepared by an independent, certified public accountant for a publicly-held corporation?

This issue is of importance to a substantial number of the Chamber's publicly-held corporate members. It also concerns the Chamber's non-public members, since the I.R.S. actions in this case raise the spectre that it may well take the same position with the non-public members of the business community.

The tax analysis (or accrual) workpapers contain a corporation's "worst case" estimate of its contingent tax liability based on the issues it thinks might be raised in an audit of its tax returns, and its speculation concerning the ultimate resolution of those issues. As such, they constitute a road map to a corporation's negotiating and settlement positions on issues discussed therein.

The concern of the Chamber's members is heightened by the fact that preparation of the tax accrual workpapers is not a discretionary matter for publicly held corporations. To the contrary, the Securities and Exchange Commission ("SEC") requires publicly held corporations to file periodically audited financial statements. SEC regulations,[3] and the standards of the accounting profession[4] require that these financial statements disclose "material contingent liabilities." The possibility of additional

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[3] Regulation S-X, 17 C.F.R. 210.1-02(n) (1981).

[4] American Institute of Certified Public Accountants, Statement on Auditing Standards No. 1, 110.01 (1973); *Financial Accounting* Standards Board, Statement of Financial Accounting Standards No. 5 (1975).

tax liability is normally considered to be a material contingent liability.

The Chamber is concerned that if the Internal Revenue Service's position is adopted, it will substantially interfere with the ability of management of publicly held corporations to have full and frank discussions with their independent auditors. Such a result would not only be a detriment to the publicly held members of the Chamber, but to the substantial number of the Chamber's members who rely on complete financial reporting in order to invest in publicly held corporations.

SUMMARY OF ARGUMENT

Tax accrual workpapers are a corporation's estimate of its tax liability for a particular year after all tax audits, negotiations, and litigation of contested areas are completed. The workpapers are not used in any way to assist in preparation of the corporate tax return, but rather are created independently of the preparation of the return.

In large part, these workpapers are created to comply with Securities and Exchange Commission Regulations designed to insure that investors receive accurate data on the financial conditions of public corporations.[6] The Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.*, requires publicly held corporations to file financial statements, which have been verified by independent auditors "in accordance with generally accepted auditing standards".[6] To assure that the corporation's balance sheet does not present "an overly-rosy view of a corporation's financial health, [those standards require that] the balance sheet must provide for contingent future tax liabilities." [7]

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[5] *See* Regulation 2-X, 17 C.F.R. 210.1-02(n) (1981).

[6] 17 C.F.R. § 210.1-02(d).

[7] *United States* v. *El Paso Co.*, 682 F.2d 530, 534 (5th Cir. 1981), *Petition for Cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716).

In essence, the corporation sets aside these amounts to cover additional taxes that it may be liable for should the I.R.S. question the company's return.[8]

In performing the audit function, including the preparation of the tax analsyis workpapers, an "auditor acquires an intimate knowledge of the client's most private business secrets and confidences." [9]

"The accountant's evaluation of the tax contingency figure is based on an analysis of the client's records and an assessment of opinions, speculations, and projections made by the client's personnel and legal counsel regarding unclear or aggressive tax positions. The independent accountant explores tax effects with corporate officials, often on a hypothetical worst-case basis, to ensure that the tax accrual figure accurately reflects the full extent of the client's exposure to additional tax liability." (Footnotes omitted) Caplin, *Government Access to Independent Accountants' Tax Accrual Workpapers*, 1 Va. Tax Review 59-60 (Spring, 1981)

Disclosure of the workpapers will inevitably result in disclosure of these confidences, thereby inhibiting full and frank communications between corporations and their accountants. Therefore, there is a basic tension between the policies underlying the federal securities laws and the I.R.S.'s attempts to obtain the documents at issue here.

As the court below found, that tension should be resolved by denying the I.R.S. the documents they seek here. The documents were not used to prepare the returns in question and are not necessary for the I.R.S. to assess the correctness of the returns.

Even if the significant conflict between the securities laws and the I.R.S. attempts to obtain these documents is

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[8] *Id.*

[9] Note, *Government Access to Corporate Documents and Auditor's Workpapers: Shall We Include Auditors Among the Privileged Few?*, Winter 1977. J. Corp. L. 353.

put aside, the I.R.S. should be denied access to the documents on the basis that absent allegations of fraud, they are not relevant to an I.R.S. investigation. *United States* v. *Coopers and Lybrand*, 550 F.2d 615 (10th Cir. 1977).

As noted above, the workpapers are prepared independently of the tax return, and are not a factual source for preparation of the return. The Government's contention that anything that "might throw light" on the correctness of the return is relevant is no standard at all, since anything even tangentially related to the subject of taxes would meet the standard. Such a standard provides little protection to businesses from I.R.S. overzealousness.

ARGUMENT

I. THE POLICIES UNDERLYING THE FEDERAL SECURITIES LAWS JUSTIFY ACCORDING INDEPENDENT AUDITOR'S TAX ANALYSIS WORKPAPERS A QUALIFIED WORK-PRODUCT PRIVILEGE.

The policy underlying our federal securities laws is that all investors in publicly held corporations should be entitled to the most complete financial information possible.[10] Any government action which impedes this policy must be seriously questioned. The I.R.S. attempts to obtain tax analysis workpapers is precisely such governmental action. It is for this reason that the court below found a qualified privilege for tax analysis workpapers. *U.S.* v. *Arthur Young and Co.*, 677 F.2d 211, 220 (2d Cir. 1982).

In preparing tax analysis workpapers, the independent auditor "explores tax effects with corporate officials, often

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[10] The Chamber is a strong advocate of this policy. Its policy manual states: "it is essential that legislation which assures investors of the availability of adequate information regarding proposed issues of securities continue in force." *Policy Declarations Adopted by the Chamber of Commerce of the U.S.*, pp. 183-184 (1981).

on a hypothetical worst-case basis." Caplin, *supra* at 60. Of particular significance is the fact that the workpapers "pinpoint issues of concern to the taxpapers and present careful estimates of the likelihood that the Service will prevail in the case of controversy." *Id.* As the Second Circuit observed in this case: [11]

> "The inquiry necessarily lays bare not only the auditor's thoughts but also the taxpayer's basic thinking, including decisions not to litigate that are based on considerations wholly apart from the inherent legality of what the taxpayer has done, e.g., the cost of litigation and the possibility that confidential information may be disclosed to competitors.

Id. at 220.

Obviously, one of the primary incentives for a corporate client to engage in such a soul-baring exchange is the auditors' ethical obligation not to disclose information obtained in the course of an audit.[12] However, if corporate officials realize that this information will be obtained by the I.R.S. through access to the auditor's tax analysis workpapers, they may well be less than candid with the independent auditors. *United States v. Arthur Young and Co.*, 677 F.2d at 220.

This sensitivity was articulated by a past president of the American Institute of Certified Public Accountants in *United States* v. *Coopers and Lybrand*:

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[11] One commentator has observed that, "[t]he relationship between a corporation and its auditor is essentially confidential. In the course of an audit examination, the auditor acquires an intimate knowledge of the client's most private business secrets and confidences." (footnotes omitted) Note: *Government Access to Corporate Documents and Auditors' Workpapers: Shall We Include Auditors Among the Privileged Few?*, *supra* at 353.

[12] American Institute of Certified Public Accountants, Code of Professional Ethics Rule 301 provides: "A member shall not disclose any confidential information obtained in the course of a professional engagement except with the consent of the client."

> . . . I would not presume to suggest, Your Honor, that a taxpayer, be it a large corporation or a small one, be empowered in any way to withhold the facts on which they have based their income tax return or the basis on which they have computed their tax. This certainly is part and parcel of our system of self assessment, and were we to eliminate that, the Government would be terribly hampered, but what I'm concerned about is this ability of the Government to look into the client's mind to determine not what the facts are on which the tax is based, but what the worst possible nightmare is the client can conceive can happen if every assumption on which he based his tax were to go against him in some kind of litigation.
>
> He may think up contingencies even more lurid than the worst contingencies a revenue agent comes up with, and with that information available to the revenue agent just for the asking, I think eventually destroy the system of auditing that we have established because it would eliminate the freedom that the client feels of being able to muse with us about, well, what if this capital gains is treated as an ordinary income? What are the potentials? What are the chances? Well, the chances are 60-40 or 90-10, one way or the other.
>
> • • •
>
> If we were hampered in any audit situation by the fact that the client knows that if he gives us any data about that its going to be readily available to Government, I cannot imagine how we would be able to render audit opinions for that client for very long. It would just absolutely cut off our communication . . .

413 F. Supp. 942 at 953-954 (D. Colo. 1975), *aff'd.*, 550 F.2d 615 (10th Cir. 1977)

The Chamber is greatly concerned about the ramifications of such a "cut off" in communications. The ability of investors to obtain complete and accurate financial

data is crucial to our economic system. If a "prudent organization might not be perfectly candid with [its] independent auditors," [13] investors are likely to suffer. Moreover, as discussed *infra* at 11-12, the I.R.S. attempts to obtain tax analysis workpapers will adversely impact our system of taxation which heavily relies on voluntary compliance and self-assessment.

Accordingly, the Chamber urges the Court to affirm the Second Circuit's application of *Hickman* v. *Taylor*, 329 U.S. 495 (1947), to the situation presented here, by establishing a qualified work-product privilege for tax accrual workpapers.

The need of the I.R.S. for the information must be balanced against the strong public policies in favor of maximum disclosure to independent auditors.

II. TAX ANALYSIS WORKPAPERS SHOULD NOT BE CONSIDERED RELEVANT PURSUANT TO I.R.C. SECTION 7602, ABSENT AN ALLEGATION OF FRAUD OR A SHOWING OF COMPELLING NEED.

Although the Second Circuit found tax analysis workpapers to be protected from disclosure by a qualified work-product privilege, it rejected Arthur Young's contention that such workpapers are not relevant under I.R.C. section 7602. The Chamber believes the Second Circuit erred in this regard, and urges this Court to reverse that holding.

In *United States* v. *Powell*, 379 U.S. 48 (1964), this Court articulated four requirements that must be present for the I.R.S. to obtain enforcement of a section 7602 summons:

> [The I.R.S.] must show that the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, that the information sought is not already within the Com-

[13] *United States* v. *Arthur Young and Co.*, 677 F.2d at 220.

> missioner's possession, and that the administrative steps required by the Code have been followed.

379 U.S. at 57-58.

It has also been said that *Powell* established a fifth requirement, that the I.R.S. use its summons authority in good faith, Caplin, *supra*, at 63.

The primary question presented is whether tax analysis workpapers are relevant to an I.R.S. investigation absent an allegation of fraud, or a showing of compelling need. In holding that tax analysis workpapers are relevant, the Second Circuit expressly disagreed with the holding of the Tenth Circuit in *Coopers and Lybrand*, and the related holding of the Eighth Circuit in *United States* v. *Matras*, 487 F.2d 1271 (1973). The test of relevance used by the Second Circuit was whether the requested documents "might have thrown light upon the correctness of the return." *United States* v. *Arthur Young*, 677 F.2d at 218.

The Chamber believes the Second Circuit's litmus test is far too broad, encompassing almost anything the I.R.S. wishes to obtain. In this regard, the Tenth Circuit in *Coopers and Lybrand*, quoting from an opinion of the Eighth Circuit, stated:

> "If we were to acceed to the government's view, it is difficult to imagine corporate materials that might not contribute to a more comprehensive understanding of the workings of the corporation, and thus, according to the government, be deemed relevant to the tax investigation."

550 F.2d at 621, *quoting*, *U.S.* v. *Matras*, 487 F.2d at 1274-1275.[14]

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[14] Interestingly, the Eighth Circuit in *Matras* began its inquiry as to whether the documents sought were relevant, with the same test used by the Second Circuit here: whether the sought after documents "might have thrown light upon the correctness of the taxpayer's return." 487 F.2d at 1274. Whether "light is thrown must

In preparing a tax pool analysis,

> . . . the auditors and corporate management engage in a worst-case analysis of the tax treatment of selected items on the corporation's return. A worst case tax assessment is then computed and a portion of this amount is accrued or reserved. This process takes place separately from the preparation of the actual tax return, regardless of whether the corporation also has engaged the auditing firm to prepare the corporation's tax return. (footnotes omitted)

Note, *A Balancing Approach to the Discoverability of Accountants' Tax Liability Workpapers Under Section 7602 of the Internal Revenue Code*, 60 Wash. U.L.Q. 185 (1982)

Precisely because preparation of this analysis is done independently of preparation of the corporation's tax return, and is in no way a factual predicate for the company's tax return, the analysis should not be considered relevant to an I.R.S. investigation.[15] *U.S.* v. *Coopers & Lybrand*, 550 F.2d at 618-621.

The Chamber believes that former I.R.S. Commissioner Caplin's view of the law is far more reasonable than

---

be a realistic expectation, rather than an idle hope." *Id.* The Court then went on to say:

> Certainly, a taxpayer should not erect roadblocks for the purpose of frustrating or preventing the I.R.S. from a full scale inquiry of the liability of the taxpayer. By the same token, the government should not for the mere sake of its convenience, impose unnecessary burdens on a taxpayer in conducting an audit or investigation for tax liability, particularly, where, as here, there is no indication of a purpose to escape any tax liability. The term "relevant" connotes and encompasses more than "convenience."

Id. at 1274-1275; *Quoted with approval in, U.S.* v. *Coopers & Lybrand*, 550 F.2d at 620-621.

[15] An allegation of fraud by the Service may well lead to a different conclusion as to the relevance of the analysis. But no allegation of fraud has been made here, and that question can therefore be left for another case.

that asserted by the Service here. Caplin states that the "quantum of proof necessary to show relevance" is not static, but varies according to the circumstances. Caplin, *supra* at 65. In each case, the touchstone is reasonableness. *Id.* Where, as here, the documents contain no factual material used to prepare the return, the materials are sought from third parties such as Arthur Young,[16] and the documents were created for purposes other than compliance with the Internal Revenue Code, a far greater showing of relevance is necessary. *Id.* at 65-68.

Under circumstances such as these, the I.R.S. burden should be a heavy one. That burden cannot be met solely by the government's need for a "road map." *United States* v. *Matras*, 487 F.2d at 275. *Accord*, *United States* v. *Coopers & Lybrand*, 550 F.2d at 621.

As we noted previously, inherent in the determination of whether a section 7602 summons should be enforced is whether the I.R.S. position is reasonable. *See supra* p. 9. The Chamber believes I.R.S. attempts to obtain tax analysis workpapers violate concepts of fundamental fairness, and therefore are unreasonable. As one commentator has noted:

> A corporation has a legal right to decrease its taxes by means that it determines are in conformance with the law. Requiring disclosure of the arguments the taxpayer conjures up against this position is untenable. The self assessment system is buttressed by the broad investigatory powers of the I.R.S., but it is also grounded in an assumption of fair play by both sides. A requirement that the taxpayer, in effect, prepare the I.R.S.'s case against his position is beyond the bounds of fair play and is thus disruptive to the self assessment system. (footnotes omitted)

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[16] *United States* v. *Harrington*, 388 F.2d 520, 523 (2d Cir. 1968); *United States* v. *Theodore*, 479 F.2d 749, 754 (4th Cir. 1973); *United States* v. *Coopers and Lybrand*, 550 F.2d at 621.

Note, *A Balancing Approach to the Discoverability of Accountants' Tax Liability Workpapers Under Section 7602 of the Internal Revenue Code*, 60 Wash. U.L.Q. *supra* at 207).[17]

Justice Jackson statement in his concurring opinion in *Hickman* v. *Taylor*, 329 U.S. at 516, is applicable here: "Discovery was hardly intended to enable a learned profession to perform its functions . . . on wits borrowed from its adversary."[18]

CONCLUSION

For the foregoing reasons, the Chamber of Commerce of the United States respectfully urges this Court to affirm the holding of the U.S. Court of Appeals for the Second Circuit that tax analysis workpapers are subject to a work-product privilege, and reverse the holding of that court that those workpapers are relevant to an I.R.S. investigation where there has been no allegation of fraud.

Respectfully submitted,

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[17] Similarly, former Commissioner Caplin states: "The federal income tax system is based upon cooperation by the public through voluntary compliance and self-assessment of taxes to preserve this process the *Service* must treat taxpayers in a fair, even-handed manner, and demonstrate to the public that it is doing so." Caplin, *supra* at 82.

[18] Quoted in *Upjohn Co.* v. *United States*, 449 U.S. 383 at 396 (1981).

No. 82-687

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IN THE

Supreme Court of the United States

October Term, 1982

UNITED STATES OF AMERICA,

Petitioner,

v.

ARTHUR YOUNG & COMPANY

and

AMERADA HESS CORPORATION,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF *AMICUS CURIAE* OF THE COMMITTEE ON CORPORATE LAW DEPARTMENTS OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

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BRIEF *AMICUS CURIAE* OF THE COMMITTEE ON CORPORATE LAW DEPARTMENTS OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

INTEREST OF *AMICUS CURIAE*

The Association of the Bar of the City of New York (the "Association") is a voluntary membership organization of the legal profession in New York City. Its members are private and public practitioners, trial and appellate judges in state and federal courts, legislators and law professors. Since its inception in 1871 the Association has taken an active interest in important legal issues. The Committee on Corporate Law Departments (the

"Committee") is a standing committee of the Association and is composed of chief legal officers of major corporations in the New York City area.

The Committee appears in this case as *amicus curiae* to argue that the public interest in dependable corporate financial data upon which, in part, the public disclosure process of the federal securities laws rests, deserves precedence over the interest of the Internal Revenue Service ("IRS") in unlimited disclosure of the thought process of auditors and their clients, because the IRS has available to it other sources of information and the powerful legal process of 26 U.S.C. § 7602 with which to investigate the adequacy of reporting to the IRS by a taxpayer of its tax liability.

Lawyers play a crucial role in the public disclosure process mandated by the federal securities laws. They are intimately involved in the procedures whereby publicly held companies fulfill their responsibilities in this area. Indeed, in recent years the Securities and Exchange Commission ("SEC") has sought to increase the role of attorneys in connection with the disclosure process. A continuing problem faced by lawyers has been the extent to which communications between them and their clients or their client's independent auditors may take place on the full and frank basis so central to the policies underlying the federal securities laws without prejudicing the client by exposing the communication to discovery by a party adverse to the client.

Candor in assisting an auditor depends upon a sense of confidence that the information a lawyer relates to a client's auditor will remain confidential. This is particularly true in the area of tax liability. The application of the tax laws to corporate transactions often involves close judgment calls. The circuits themselves have not always been able to agree on the interpretation of the complicated provisions that govern the taxation of corporate transactions. Thus, in giving guidance to their clients on tax matters, tax lawyers must often make predictions as to the position that the IRS or courts will take on unsettled issues. These assessments are vital to the process of establishing adequate tax reserves and find their way into the auditor's work papers either

directly via communications from the lawyer to the auditor or indirectly through communications from the client derived from opinions of the tax lawyer.

If the IRS is afforded an absolute right to obtain the work papers, it becomes privy to these delicate exercises of judgment by tax lawyers. Moreover, the IRS, by seeing how the tax lawyers and their clients assess the strength of a particular position, will receive an invaluable advantage in the settlement process, which is the end product of most audits. In some cases, indeed, the IRS will even learn from the work papers the figure or range at which the taxpayer, on the advice of his tax lawyer, is prepared to compromise a tax issue. This makes the whole tax audit process so lopsided that it can only inhibit the exchange of frank opinions and figures between tax lawyers, their clients and the auditors.

Accordingly, we believe that the Bar has a significant interest in supporting the authority of the federal courts to continue to develop appropriate doctrines protecting confidential disclosure as exemplified by the decision of the Court of Appeals. The establishment and definition of such limitations on the power of the IRS to obtain an auditor's judgments on the adequacy of a client's tax accrual reserve, and the thought process supporting such judgment, should be left to the courts.

In addition, the Bar has a particular responsibility to resist Governmental efforts to adopt practices which are at variance with elementary fairness. The Government has been frank to admit in its briefs that the IRS is seeking access to auditors' opinions, theories and judgments about the propriety of the taxpayer's reporting positions and the taxpayer's state of mind. In a democratic society, it is fundamentally unfair to permit the Government to penetrate such confidential thoughts of taxpayers (absent allegations of fraud or crime), particularly where the effect of such access may be to undercut the candor and breadth of disclosures by taxpayers to their auditors and thereby risk compromising the procedures designed by Congress to protect investors from inaccurate financial information.

All parties have consented to the filing of this *amicus curiae* brief.

OPINIONS BELOW; JURISDICTION; STATUTES INVOLVED

We adopt the statement of the Opinions Below, Jurisdiction, and Statutes Involved set forth in Petitioner's brief.

SUMMARY OF ARGUMENT

The issue presented here raises the question of whether the IRS can lay bare the thoughts and legal theories of a taxpayer and its independent auditor. The IRS would like to obtain the theories and thoughts that are set forth in an auditor's tax accrual workpapers because they will serve as a "roadmap" for its audit. The main thrust of the Government's argument rests on convenience and not on a need to ascertain the correctness of tax returns. By seeking to take a "short cut" the government will compromise important federal policies.

The court of appeals properly rejected "considerations of [IRS] convenience", *Upjohn Co. v. United States*, 449 U.S. 383 (1981), and acted well within its authority by establishing a doctrine to protect the tax accrual workpapers of auditors from production to the IRS pursuant to its subpoena under 26 U.S.C. § 7602. The fact that a privilege which limits disclosure of such workpapers to the IRS in appropriate circumstances has not previously been established by this Court is not dispositive of the issue presented.

The court of appeals protected tax accrual workpapers from production to the IRS because of the clear prejudice that would flow from IRS access to an auditor's analysis and the taxpayer's basic thinking, much of which was developed after the tax return at issue has been filed. To give the IRS access to an auditor's tax accrual workpapers, absent an allegation of fraud or a showing of overwhelming necessity, is fundamentally and inherently unfair. It unnecessarily expands the IRS' power to intrude itself into the thought and decision-making processes of a taxpayer, its tax

lawyers, and its auditors. Disclosure of this information gives the IRS a devastating advantage, especially when it has not shown any need for such an advantage.

Moreover, to permit the IRS to summons an auditor's tax accrual workpapers will inhibit candid communication with auditors which will serve to compromise the integrity of the auditing process. As a result, the Congressional objective of accurate and adequate disclosure of financial information to the investing public will be harmed.

ARGUMENT

I.

THE WORK PRODUCT DOCTRINE FOR INDEPENDENT AUDITORS' TAX ACCRUAL WORKPAPERS SUPPORTS THE INTEGRITY OF AUDITED FINANCIAL STATEMENTS AND THE RELIABILITY OF THE INDEPENDENT AUDIT PROCESS.

A. The IRS is seeking to penetrate confidential thoughts and communications of a taxpayer and its auditor.

Tax collection is a pragmatic business. IRS and taxpayer personnel negotiate tax issues in a manner similar to that of representatives of other litigants. As the court of appeals said below:

> In reality, at the end of an audit, the IRS and the taxpayers frequently compromise out their differences, each giving in a little. Such negotiations strike an appropriate balance between collecting revenue and conserving judicial resources, but requiring the taxpayer alone to disclose settlement positions would improperly weight the balance.

United States v. Arthur Young & Co., 677 F.2d 211, 220 (1982). Both the IRS and the taxpayer have justifiable reason for satisfaction in a settlement that falls within their respective estimates of liability if adjudicated.

It would be easy to understand the outrage of a commercial litigant if his counsel were compelled by the court to reveal to the

adversary all of the information in counsel's possession covered by the attorney-client and attorney work-product privileges, especially if the adversary's counsel were compelled to reveal nothing. Similarly, a taxpayer whose independent auditor is compelled by 26 U.S.C. § 7602 to reveal to the taxpayer's adversary, the IRS, all information obtained by the auditor on issues bearing on the taxpayer's potential tax liability, all of which would be privileged if instead it were information of the taxpayer's lawyer, is justifiably outraged for the same reason.

The government claims that "the Service's chief interest is to discover the relevant facts" (Pet. br. at 10; also see 26-27). If that is the case, the government should pursue other sources, especially primary sources - the taxpayer's personnel and records.

In actuality, however, it turns out the IRS is looking past the facts toward something else:

> The *point* of the tax accrual workpaper process is to organize the facts; the papers will in effect embody the taxpayer's and the accountant's judgments about which facts are *relevant* to the taxpayer's lawful tax liability.

Pet. br. at 25-26. It is clear enough that the IRS *really* wants: "access to the accountant's 'opinions' and 'theories'" (*id.*), even though the brief says that such access is not the primary objective (*id.* at 10); "the accountant's - and, indirectly, the taxpayer's - opinions and judgments about the propriety of the corporation's reporting positions and about the potentials for and strength of an IRS challenge to those positions" (*id.* at 26); ". . . highlighting the vulnerabilities of the taxpayer's positions and . . . suggesting alternative theories" (*id.* at 27; similarly, at 10); "They [the tax accrual workpapers] may also shed important light on the taxpayer's state of mind . . . ; this evidence may bear on liability for fraud and other penalties." (*id.* at 10; similarly, at 25). Some of this information comes from attorneys.

In other words, the IRS wants the taxpayer's and auditor's innermost thoughts on the possible existence of potential *issues*,

their *evaluations* of those issues, their admissions as to weaknesses and *vulnerabilities*, and betrayals of the taxpayer's "state of mind" for threats of fraud and other penalties.

In order to justify a search for admission of taxpayer fraud in tax accrual workpapers, the government should be engaged in a criminal or civil fraud investigation, and should have adequate reason to believe that the workpapers or the related communications by the taxpayer to its auditor are a part of the fraud itself. Otherwise, it is basically offensive to ordinary concepts of fairness for the IRS to be attempting to penetrate confidential thoughts and communications of taxpayer and auditor for unrelated bona fide purposes to fulfill professional requirements, including, in the case of many taxpayers, the federal securities statutes.

The government brief (Pet. br. at 12, 40) and the dissenting opinion in the Court of Appeals (677 F.2d at 222-23) are both based on the unrealistic assumption that because of the requirements of the federal securities laws, the information available to independent auditors concerning their clients' potential tax liabilities would remain unaffected if a privilege for the auditors' tax accrual workpapers were to be denied. A modest acquaintance with human nature will confirm the contrary. If a person feels secure that his statements will be held in confidence, he will speak much more expansively and fully than he would otherwise. An audit client or attorney who is concerned that the client's confidence to his auditor will be scrutinized by the IRS will be much more guarded with his information than otherwise, and the auditor will learn much less.

B. The Work Product Doctrine Properly Protects the Integrity of the Audit Process

It is clear that the powers of the IRS to compel disclosure pursuant to a subpoena under 26 U.S.C. 7602 are not absolute. Courts have the power to modify or balance in appropriate circumstances the broad summons power given to the IRS. *United States* v. *Euge*, 444 U.S. 707, 716 & n.9 (1980). It is well

established that common law privileges serve to limit the scope of the IRS' summons power. *Upjohn* v. *United States*, 449 U.S. 383 (1981).

Privileges or doctrines limiting disclosure are "an exception to the general liability of every person to give testimony upon all facts inquired of in a court of justice." 8 J. WIGMORE, EVIDENCE § 2285 (McNaughton ed. 1961). Accordingly, privileges "are not lightly created nor expansively construed." *United States* v. *Nixon*, 418 U.S. 683, 710 (1974). "Their sole warrant is the protection of interests and relationships which, rightly or wrongly, are regarded as of sufficient social importance to justify some incidental sacrifice of sources of facts needed in the administration of justice." C. MCCORMICK, MCCORMICK'S HANDBOOK OF THE LAW OF EVIDENCE § 72 (2d ed. 1972).

The merits of an existing privilege or doctrine limiting disclosure should be examined flexibly with consideration of conditions and imperatives then prevailing. "Changing circumstances require courts constantly to review the need for and extent of existing privileges .... Similarly, as an evolving society engenders new relationships, courts must consider whether interests are created that require some form of protection." *In re LTV Securities Litigation*, 89 F.R.D. 595, 621 (N.D. Tex. 1981).

An auditor's tax accrual workpapers deal primarily with judgments, opinions and thoughts and to the extent any facts are included they are readily available to the IRS directly from the taxpayer. In consequence, we submit that the merits of the new doctrine for tax accrual workpapers of independent auditors are so evident and so substantial, and the inconvenience to the government (especially with the "substantial need" and "undue hardship" qualification) is so minor, that the doctrine should be recognized by this Court.

A considerable portion of the government's brief (Pet. br. at 28-42) is devoted to the argument that "the creation of this new privilege was unwarranted, and rested on significant errors in the court's analysis" (Pet. br. at 21). The essence of this argument is

simply that since the characteristics of the new privilege for auditors' tax accrual workpapers differ in part from those of existing privileges, adoption of the privilege is unacceptable. The opinion in *United States* v. *El Paso Co.*, 682 F.2d 530 (5th Cir. 1982), *petition for cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716), involving the parallel though distinguishable issue of tax accrual workpapers prepared by a company's internal accountants and lawyers, is a judicial example of that line of reasoning.[1] If that approach had been applied consistently throughout the past several centuries, there would today be no common-law privileges or the attorney work-product doctrine.

The Court of Appeals below said clearly that it was *carving out* a new "work-product privilege, similar to the [attorney] privilege fashioned in *Hickman*." 677 F.2d at 221. "Similar" and "analogy", 677 F.2d at 223 (Newman, J., dissenting), connote not only similarities, but also some dissimilarities. Extended argument directed to the nonconformity and irreconcilability of the new privilege with existing privileges never reaches the real issue before this Court—whether the nature of auditors' tax accrual workpapers merits the qualified limited privilege recognized by the Court of Appeals.

In *In re LTV Securities Litigation*, 89 F.R.D. 595, 618 (N.D. Tex 1981), the court created a "hybrid" privilege, with the observation that "[t]he privilege here recognized is neither an attorney-client nor work-product privilege, although it draws from both." *Id.* at 622. The privilege applied to testimony demanded of, and documents submitted to or prepared by, an attorney retained by a corporate audit committee as a "special officer," pursuant to a consent decree in an SEC injunction suit under the securities laws, with responsibility for investigating alleged corporate irregularities, and with reporting responsibilities both to the audit committee and to the SEC. The court rejected the contention by a class of plaintiff shareholders in a related private litigation "that

1. In *El Paso* the court of appeals found that the work-product doctrine was unavailable because the documents involved had not been prepared "in anticipation of litigation" as would be required to protect an attorney's work-product under Rule 26(b). 682 F.2d at 542.

unless the Special Officer fits squarely within the attorney-client privilege or the work-product rule, he cannot assert any privilege against their discovery", *id.* at 621, stating that:

> Both the attorney-client and work-product privileges were judicially created concepts. Their history has shown them to be reasonably flexible. Their precise dimensions have been proved to be sufficiently malleable to fulfill their central purposes as the nature of the circumstances under which they were asserted have changed. The class' argument is ultimately premised upon a rigidity of concept these privileges were never saddled with. Despite decades of refinement, the outer limits of the privileges are still amorphous. . . . The very nature of the subject precludes the type of wooden application of inflexible rules urged upon this court.

Id.

The court went to the heart of the issue - the intrinsic merits of a privilege fashioned to the need of the particular circumstances. Examining separately the two roles of the special officer's hybrid function, as private investigating counsel and government investigator, the court concluded that most if not all of the information sought by the plaintiff class would have been protected either by the attorney-client and work-product privileges or by federal statute and SEC rules, respectively. The court concluded that the "legitimate needs" (*id.* at 618) of LTV and of the SEC and the effective execution of the dual assignment justified the recognition of an unconventional privilege. *Id.* at 614-21.

II.

IT IS UNNECESSARY FOR THE IRS TO INVADE THE CONFIDENTIAL RELATIONSHIP BETWEEN A TAXPAYER AND ITS AUDITOR.

In view of an inherent indefiniteness of what constitutes adequate disclosure under the securities laws, some audit clients may take varying amounts of risk to avoid the danger of betrayal to the IRS. In *In re Hampers*, 651 F.2d 19, 23 (1st Cir. 1981), the court

said critically that "The United States blithely asserts that criminal and other sanctions provide more than enough teeth to guarantee continued compliance with the tax laws." In that case, the court recognized a new qualified privilege from disclosure of state sales tax returns to a federal grand jury. In the present case, the government is making the same assertion as to compliance by taxpayers with the federal securities laws.

Similar judicial reasoning appears in the majority opinion in the recent *United States v. Sells Engineering, Inc.*, 103 S.Ct. 3133 (1983), in which this Court interpreted the Federal Rules of Criminal Procedure as denying a right of automatic access to grand jury materials by Department of Justice Civil Division attorneys preparing a related civil suit, and as requiring a specific court order based upon a "strong showing of particularized need for grand jury materials. . . ." *Id.* at 3148. As the opinion observes (*id.* at 3142), automatic disclosure

> renders considerably more concrete the threat to the willingness of witnesses to come forward and to testify fully and candidly. If a witness knows or fears that his testimony before the grand jury will be routinely available for use in governmental civil litigation or administrative action, he may well be less willing to speak for fear that he will get himself into trouble in some other forum.

The duty of a grand jury witness to testify, and the dangers of lack of candor (*e.g.*, charges of perjury, contempt, obstruction), are much more pointed than the nature of the duty of an audit client to discuss his potential tax problems with his auditor. Even in the much stronger grand jury situation, this Court declined to accept the government's assertion that the existence of a duty to disclose can be depended upon to assure that a person will not be deterred from disclosing by the danger of prejudicial consequences from his disclosure. Also, the opinion dissipates any force in the argument of the dissenting opinion below that "The majority's privilege for accountants may be the first instance of a court creating a privilege to facilitate compliance with duties already imposed by law." 677 F.2d at 224 [footnote omitted].

The IRS has awesome power under 26 U.S.C. § 7602 to extract information both from primary sources, *i.e.*, the executives and other personnel and the records of taxpayers, and from other sources. The section states in sweeping generality that in "ascertaining the correctness of any return . . . [or] determining . . . liability . . . for any internal revenue tax . . . , the Secretary . . . is authorized . . . [t]o examine any . . . data which may be relevant or material . . . [and] [t]o summon . . . any . . . person . . . to produce such . . . data, and to give such testimony, under oath, as may be relevant or material to such inquiry. . . ." 26 U.S.C. § 7602.

In all but a few exceptional cases, the power in that section makes it unnecessary for the IRS to commit the gross unfairness of compelling the production of information that should remain confidential between a taxpayer and its auditors. As the Court of Appeals below said of the qualified character of its new doctrine:

> At the same time, it allows the IRS to procure these documents when the rare situation arises where it can make a sufficient showing of need to adequately justify invading the integrity of the auditing process, cf. *Hickman*, 329 U.S. at 512-13, 67 S.Ct. at 394, Fed.R.Civ. 26(b)(3).

677 F.2d at 221 [footnote omitted]. The cited portion of Federal Rule of Civil Procedure 26(b)(3) derived from *Hickman* v. *Taylor*, 329 U.S. 495 (1947), permits discovery despite the attorney work product privilege

> only upon a showing that the party seeking discovery has substantial need of the materials in the preparation of his case and that he is unable without undue hardship to obtain the substantial equivalent of the materials by other means. In ordering discovery of such materials when the required showing has been made, the court shall protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of an attorney or other representative of a party concerning the litigation.

FED. R. CIV. P. 26(b)(3).

Such a qualification enables a court in a particular controversy to assure that the government's investigation is not impeded unfairly for lack of access to tax accrual workpapers.

III.

CREATION OF A DOCTRINE TO PROTECT THE TAX ACCRUAL WORKPAPERS OF INDEPENDENT AUDITOR IS WITHIN THE AUTHORITY OF THE FEDERAL COURTS.

A. Federal courts are authorized to create rules of privilege.

The common law of privilege and doctrines limiting disclosure are a product of judicial formulation over centuries of experience. The power of the federal courts to continue to develop rules of privilege is clear from the language of Federal Rule of Evidence 501, the committee reports of the congressional deliberations upon the Federal Rules of Evidence, and interpretations by this Court and the lower courts. Rule 501 provides in part that:

> [T]he privilege of a . . . person . . . shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience.

FED. R. EVID. 501.

Further, the committee reports of both the Senate and the House of Representatives specify that the law of privilege is "to be developed by the courts of the United States." S. REP. No. 1277, 93d CONG., 2d SESS.6 (1974); H.R. REP. No.650, 93d CONG., 1st SESS. 8 (1973). Rule 501 was adopted in lieu of an alternative proposal that would have codified the rules of privilege, tending to freeze them in a statutory mold. 23 WRIGHT & GRAHAM, FEDERAL PRACTICE AND PROCEDURE § 5422 at n.46 (1980).

This Court has said that in

> enacting Rule 501, Congress manifested an affirmative intention not to freeze the law of privilege. Its purpose rather was to "provide the courts with the flexibility to develop rules of privilege on a case-by-case basis," 120 Cong. Rec. 40891 (1974) (statement of Rep. Hungate), and to leave the door open to change.

Trammel v. *United States*, 445 U.S. 40, 47 (1980). In *Upjohn Co.* v. *United States*, 449 U.S. 383, 396-97 (1981), involving an internal revenue summons under 26 U.S.C. § 7602, this Court relied in part upon rule 501 in adopting the more expansive of the disputed interpretations of the attorney-client privilege.

The lower courts have interpreted this Court's statements as authorizing them to consider the adoption of new rules of privilege not existing at the time of the enactment of rule 501. *See, e.g., Gray* v. *Board of Higher Education, City of New York*, 692 F.2d 901, 904-05 (2d Cir. 1982), and *In re Dinnan*, 661 F.2d 426, 429 (5th Cir. 1981), *cert. denied*, 457 U.S. 1106 (1982) (both opinions considering and rejecting a privilege as to votes cast on academic tenure); *United States* v. *Green*, 670 F.2d 1148, 1155 (D.C. Cir. 1981) (recognizing a qualified privilege protecting police surveillance locations from disclosure); *In re Hampers*, 651 F.2d 19, 23 (1st Cir. 1981) (recognizing a qualified privilege from disclosure to a federal grand jury of state sales tax returns); *Ott* v. *St. Luke Hospital of Campbell County*, 522 F. Supp. 706, 708 (E.D. Ky. 1981) (considering and rejecting a privilege for deliberations of hospital peer review committee); *In re LTV Securities Litigation*, 89 F.R.D. 595, 618-21 (N.D. Tex. 1981) (recognizing a "hybrid" qualified privilege for work-product of attorney appointed special officer pursuant to decree in SEC enforcement suit).

The discretion of the federal courts in this area, confirmed by Congress in its approval of rule 501, refutes the contention made in the dissenting opinion below (677 F.2d at 22) and quoted by the government (Pet. br. at 8) that the courts should leave the recognition of new privileges to Congress.

B. In adopting a doctrine to protect an independent auditor's tax accrual workpapers, the Court of Appeals properly performed the judicial function of harmonizing conflicting federal statutory policies.

The government asks this Court to deny protection for an independent auditor's tax accrual workpapers by citing canons of

statutory construction that "repeals by implication are disfavored", and that conflicting statutes "capable of coexistence" are to be construed so that each is effective. Pet. br. at 44. The government's attempt to portray the recognition of the auditor's workpapers doctrine as amounting to an implied repeal of the summons provisions of 26 U.S.C. § 7602 is misguided.

The mere existence of a statute, such as 26 U.S.C. § 7602, mandating disclosure of documents does not bar the recognition of a privilege that in some cases restricts the scope of disclosure. *Cf. Administrator, Federal Aviation Administration* v. *Robertson*, 422 U.S. 255 (1975) (Freedom of Information Act construed to exempt from public disclosure certain FAA reports concerning airline safety). Where a conflict exists between policies of two statutes, as it does in this case between the securities laws and revenue laws, sole reliance on one of the two "would assume the answer to the question at issue." *Watt* v. *Alaska*, 451 U.S. 259, 266 (1981). As perceived by Judge Feinberg below, no matter how the issue is decided, "one policy has to bend a bit." 677 F.2d at 220.

By recognizing the auditor's workpaper doctrine, the Court of Appeals below fulfilled the accepted judicial function of harmonizing conflict between *ad hoc* legislative enactments, in this instance the securities laws and the revenue laws, giving "effect to each . . . while preserving their sense and purpose." *Watt* v. *Alaska*, 451 U.S. at 267. The privilege recognized in this case fosters the goals of the securities laws by promoting accurate reporting to the public without unreasonably curtailing the extensive enforcement powers of the IRS. Since the auditor's workpaper doctrine is qualified, a court may compel disclosure if the IRS can make a showing of substantial need and the inability to obtain the substantial equivalent by other means without undue hardship, sufficient to overcome the protections of the privilege. *Upjohn Co.* v. *United States*, 449 U.S. 383, 401-02 (1981). The doctrine furthers the policy of the securities acts while restraining unwarranted encroachment by the revenue laws.

CONCLUSION

For the foregoing reasons, the judgment of the Court of Appeals insofar as it reversed the District Court's order that the tax accrual workpapers be produced should be affirmed.

Dated: September 9, 1983
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No. 82-687

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

UNITED STATES OF AMERICA,
Petitioner,
v.
ARTHUR YOUNG & COMPANY, *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF FOR THE EL PASO COMPANY AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

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QUESTION PRESENTED

Whether a company's candid in-house evaluation respecting its possible tax liabilities, which embodies its legal theories as well as its negotiating, settlement, and litigation strategies, is privileged from IRS discovery, even though the company disclosed that evaluation in confidence to its accountant in order to comply with SEC financial reporting requirements.

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IN THE

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OCTOBER TERM, 1983

No. 82-687

UNITED STATES OF AMERICA,
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ARTHUR YOUNG & COMPANY, *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF FOR THE EL PASO COMPANY AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

INTRODUCTION AND INTEREST OF *AMICUS CURIAE* THE EL PASO COMPANY

The El Paso Company ("El Paso") has pending before the Court a petition for a writ of certiorari seeking review of essentially the same issue presented in this case, *i.e.*, whether tax accrual workpapers are privileged from disclosure to the IRS. In El Paso's case, the Fifth Circuit held that the workpapers must be produced (*United States* v. *El Paso Co.*, 682 F.2d 530 (1982)), while in this case ("*Arthur Young*"), the Second Circuit held that such documents are privileged. Pet. App. 30a-32a. In seeking review in *Arthur Young*, the Government relied on the conflict with *El Paso* and the need to "establish a uniform national rule with respect to the production of * * * tax accrual workpapers." U.S. Pet. 6-7. However, the Government opposed certiorari in *El Paso*, stating that the same question was already on petition in *Arthur Young*, and that it would therefore be appropriate to "hold [El Paso's] case to await the disposition of *Arthur Young & Co.*" U.S. Opp. in No. 82-716, at 15.

El Paso's first and most obvious interest in the present case, therefore, is simply that the resolution of *Arthur Young* may well control El Paso's own case. But El Paso's second and broader interest is that a ruling in this case requiring production of the workpapers will have a devastating impact nationwide on the tax-collection and financial-reporting processes. Plainly, this result is not in the interests of the business community and, as we will explain, it is directly contrary to significant public interests.

For three reasons, El Paso believes that its participation as *amicus* will assist the Court in deciding the privilege issue raised by this case.[1] First, in deciding that the tax accrual workpapers were protected, the *Arthur Young* court essentially recognized a *new* privilege. Pet. App. 30a-32a. We believe, however, that no new privilege need be created, since the workpapers are well within the traditional work-product doctrine long recognized by this Court. Yet, if the Government's brief is correct, no party in *Arthur Young* will even argue that traditional work product applies to the workpapers. U.S. Br. 34. We therefore do so in this brief, as we did in the courts below.[2]

Second, the *Arthur Young* court premised its recognition of the new privilege on a perceived conflict between the tax and securities laws. Pet. App. 28a-29a. In response, the Government argues that no conflict exists and, therefore, that no privilege is warranted. U.S. Br. 42-43. We submit, however, that no such conflict as found by the Second Circuit is required to justify recognition of the new privilege. Rather, the privilege may and ought to be sustained so long as the public interest it furthers out-

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[1] The consents of the United States and Respondents to the filing of this brief have been submitted to the Clerk of the Court.

[2] El Paso raised this privilege as a defense to production in both the District Court and Court of Appeals. See Pet. App. 21a, 44a, in No. 82-716, *petition for cert. pending*.

weighs any legitimate interest the IRS has in obtaining the documents. Relying on this balancing standard, we show below that the public's interest in the fair, efficient administration of the tax laws is more than sufficient to warrant the privilege.

Finally, while the Government opposed certiorari in our case on the ground that *Arthur Young* could fairly resolve *El Paso*, in its brief on the merits in this case the Government now opposes recognition of a privilege on the ground that the workpapers in *Arthur Young* were prepared by and summoned from an independent public accountant. U.S. Br. 29-33. But in El Paso's case, the workpapers were: (1) summoned from the taxpayer itself, and (2) prepared by the taxpayer in-house, at the direction of, and in consultation with, its in-house legal counsel. We therefore file this brief to make clear these material distinctions between *Arthur Young* and *El Paso*, and to urge that any rule premised on an accountant's preparation of the workpapers not be applied to El Paso and to similarly situated taxpayers.[3]

SUMMARY OF ARGUMENT

Tax accrual workpapers reflect taxpayers' candid legal evaluations, theories, and strategies formulated in preparation for adversary proceedings against the IRS. They are therefore well within this Court's definition of "work product." Contrary to the Government's arguments, the adversary proceedings contemplated by the workpapers

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[3] It is now clear that the majority of future IRS summonses for tax accrual workpapers will be directed to taxpayers (as in El Paso's case) rather than to their independent accountants (as in *Arthur Young*). Subsequent to the IRS's issuance of the summons in these cases, the IRS revised its guidelines for revenue agents, requiring them to summon tax accrual workpapers from the taxpayer, rather than from its independent accountant, whenever possible. I *Internal Revenue Manual (Audit)* (CCH) § 4024.4(5), at 7019-3 (1981); *see* U.S. Br. 14-15 n.4. The IRS's revised procedure assures that the issue presented in this case will recur most frequently in the context of summonses issued to taxpayers who prepare and retain such workpapers in-house, rather than to their independent accountants.

are in no sense "remote," and the fact that the work-product information was shared with the taxpayer's accountant in order to comply with SEC reporting requirements did not forfeit the work-product protection. Since the IRS has not made the requisite showing of need for the workpapers sufficient to overcome their privileged status, they are not subject to disclosure.

Even should the Court determine that the workpapers do not meet the requirements for work-product protection, they nevertheless should be deemed privileged. The public's interests in preserving the free flow of information to the securities markets and in preserving the fairness, integrity, and efficiency of the tax collection process—both of which interests are served by protecting the workpapers from disclosure to the IRS—far outweigh any legitimate IRS interest in obtaining those documents.

ARGUMENT

I. TAX ACCRUAL WORKPAPERS ARE PREPARED BY OR ON BEHALF OF THE TAXPAYER WITH A SPECIFIC VIEW TOWARD DEFENDING, NEGOTIATING, SETTLING, OR LITIGATING ITS TAX RETURN IN A SERIES OF ADVERSARY PROCEEDINGS AGAINST THE IRS; THE WORKPAPERS ARE THEREFORE PROTECTED BY THE "WORK-PRODUCT" DOCTRINE.

A. The Materials Presented In Tax Accrual Workpapers Are Well Within This Court's Definition Of "Work Product."

SEC requirements compel companies such as Amerada Hess and El Paso to file financial statements that have been audited by an independent, certified public accountant.[4] Among the items the accountant must review is the

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[4] *See* Caplin, *Government Access to Independent Accountants' Tax Accrual Workpapers*, 1 Va. Tax Rev. 57, 58 n.6 (1981); Note, *Government Access to Corporate Documents and Auditors' Workpapers: Shall We Include Auditors Among the Privileged Few?*, 2 J. Corp. L. 349, 353 n.13 (1977) (hereinafter *Auditors' Workpapers*).

company's treatment of its contingent tax liabilities.[5] To test the soundness of the amount allowed for this contingency, the accountant must be made privy to any possible "weak spots" in the company's returns, as well as to the company's intended negotiating, settling, or litigating strategies with respect to those "weak spots." To provide the accountant this information, tax accrual workpapers are generated.

In the case of a company like El Paso, the tax accrual workpapers are prepared and retained in-house by El Paso's tax compliance personnel at the direction of, and in consultation with, its in-house legal counsel. They reflect El Paso's best estimate of its ultimate tax liability for the year or years in question after all pending or potential tax audits, negotiations, refund claims, and litigation are concluded or settled; and they reflect El Paso's specific judgments on and legal strategies respecting possible tax questions raised by the return.[6] Hence, what former IRS Commissioner Caplin observed with regard to workpapers in general is indisputably true in El Paso's case: "In short, the tax accrual workpapers are the definitive road map to the vulnerable areas in a corporate taxpayer's return." Caplin, *supra*, 1 Va. Tax Rev. at 61.

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[5] *See* FASB, *Statement on Financial Accounting Standards No. 5*, ¶¶ 8, 33-39 (1975); American Institute of Certified Public Accountants ("AICPA"), *Statement on Auditing Procedure No. 50* (1971); Caplin, *supra*, 1 Va. Tax Rev. at 59; *Auditors' Workpapers*, 2 J. Corp. L. at 357.

[6] More specifically, tax accrual workpapers serve to: (1) identify issues on the corporation's federal tax returns which counsel and other tax compliance personnel think could be subject to challenge in the course of an audit because of differences with the IRS on legal interpretations or factual characterizations; (2) speculate as to the likelihood that the IRS will raise these issues; (3) evaluate whether the corporation would litigate the issues raised and estimate its chances of prevailing; (4) review and evaluate the legal implications of the issues identified; (5) estimate the dollar amounts for which the corporation would be willing to settle each controversy administratively if it chose not to litigate; and (6) assign a total estimated dollar amount to the aggregate outcome as to all issues discussed. *See Auditors' Workpapers*, 2 J. Corp. L. at 357.

El Paso and Amerada made this "road map" available to their respective accountants so that SEC reporting requirements could be met. In so doing, however, the companies relied upon their accountants' ethical obligation not to disclose the confidential information they received.[7]

Based on the foregoing nature of the documents at issue, this Court's decisions make plain that those documents are protected by the work-product privilege. Thus, in *Hickman* v. *Taylor*, 329 U.S. 495, 511 (1947), this Court declared that "[p]roper preparation of a client's case demands that [a lawyer] assemble information, sift what he considers to be the relevant from the irrelevant facts, prepare his legal theories and plan his strategy * * *." If written materials reflecting this preparation were open to adversaries on demand, said the Court, "[i]nefficiency, unfairness and sharp practices would inevitably develop * * * [a]nd the interests of the clients and the cause of justice would be poorly served." *Id.* It was therefore the fairness and efficiency of our adversary "system of jurisprudence" which the Court sought to protect through recognition of the work-product privilege. *Id.* And, as the Court subsequently made clear in *United States* v. *Nobles*, 422 U.S. 225, 238 (1975), the work-product privilege serves that system by encouraging thorough preparation and presentation of each side's case in adversary proceedings.

Furthermore, to ensure fair, effective operation of the adversary system, the Court has expressly recognized two other important applications of the work-product doctrine.

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[7] The IRS itself has recognized in its Manual that the tax accrual workpapers consist in part of opinions and projections communicated *in confidence* to the accountant. I *Internal Revenue Manual (Audit)* (CCH) § 4233, ¶ 232.8(4), at 7281-22 (1981). Moreover, the accountant is bound by professional ethics (as well as by administrative rules of all 50 states) not to disclose the information related to him. AICPA, *Professional Standards ET Section 54.02* (1979) ("It is fundamental that the CPA hold in strict confidence all information concerning a client's affairs which he acquires in the course of his engagement").

First, the privilege applies not only to materials prepared by a party's attorney, but to materials prepared either by the party itself or by anyone acting for the party. *FTC* v. *Grolier Inc.*, 103 S.Ct. 2209, 2213 (1983) (quoting Fed. R. Civ. P. 26(b)(3)); *Upjohn Co.* v. *United States*, 449 U.S. 383, 400 (1981) (quoting Notes of Advisory Committee to Fed. R. Civ. P. 26(b)(3)). Second, the privilege protects government agencies and private parties alike in their adversary dealings with each other. *FTC* v. *Grolier*, *supra*; *see NLRB* v. *Sears, Roebuck & Co.*, 421 U.S. 132 (1975). Indeed, the privilege is particularly significant in the case of government agencies and private parties who deal with each other on a continuing adversary basis for they "have an acute interest in keeping private the manner in which they conduct and settle their recurring legal disputes." *Grolier*, 103 S.Ct. at 2216 (Brennan, J. concurring). Requiring such perennial adversaries to disclose their preparatory materials would "instill an undesirable caution" in their preparation, thereby undermining the adversary process and producing "precisely the danger of '[i]nefficiency, unfairness[,] . . . sharp practices' and demoralization that *Hickman* warned against." *Id.* (footnote omitted).

We submit that the above principles apply foursquare to the tax accrual workpapers at issue here and in *El Paso*. Both Amerada and El Paso are perennial adversaries in the administrative tax process;[8] both have prepared documents (or have had documents prepared on their behalf) candidly assessing the positions taken in their tax returns and the legal theories and strategies by which they intend to negotiate, settle, or litigate those positions; and both have nevertheless had those documents subpoenaed by the IRS. The previously-described work-product principles from *Hickman*, *Nobles*, *Upjohn*, and

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[8] As the Fifth Circuit explicitly recognized in the *El Paso* case, "[t]he IRS, as it does with most giant corporations, annually audits El Paso and has been doing so since the 1940s." 682 F.2d at 533.

Grolier therefore govern both cases and protect the documents at issue.

In response, neither the Government in this case nor the Fifth Circuit in *El Paso* denies that the essence of the tax accrual workpapers is "work product"—a candid assessment of the respective parties' tax claims, along with their legal theories and strategy for defending those claims.[9] Instead, both the Government and the Fifth Circuit contend that this work-product material should be open to the IRS on demand because it was not prepared "with an eye toward litigation" within the meaning of *Hickman*. 329 U.S. at 511. There are essentially two arguments being made. The first is that the documents do not "contemplate" or "concern" litigation, since the possibility of such litigation is remote at best. U.S. Br. 34-35; *El Paso*, 682 F.2d at 543. The second argument is that the documents were not generated to assist in possible litigation, but to comply with SEC financial-reporting requirements. U.S. Br. 33-34; *El Paso*, at 543. In addition to these two arguments, the Government (but not the Fifth Circuit) also contends that, in any event, workpapers prepared by accountants should not be protected by the work-product privilege. U.S. Br. 29-33. We address each of these arguments in turn.

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[9] Indeed, the Government's own brief makes the work-product nature of the documents unmistakable: "The *point* of the tax accrual workpaper process is to organize the facts; *the papers will in effect embody the taxpayer's and the accountant's judgments about which facts are relevant to the taxpayer's lawful tax liability.*" U.S. Br. 25-26 (additional emphasis added). In addition, the Fifth Circuit expressly acknowledged that the tax accrual workpapers involve "weighing legal arguments, predicting the stance of the IRS, and forecasting the ultimate likelihood of sustaining El Paso's position in court." 682 F.2d at 543. This is work product, pure and simple, as this Court made explicit in *Hickman* itself: "Proper preparation of a client's case demands that [the attorney] assemble information, *sift what he considers to be the relevant from the irrelevant facts, prepare his legal theories and plan his strategy* * * *. Were such materials open to opposing counsel on mere demand * * * the interests of the clients and the cause of justice would be poorly served." 329 U.S. at 511 (emphasis added).

B. The Litigation Contemplated By Tax Accrual Workpapers Is Not "Remote."

To support its argument that any "litigation" contemplated by the tax accrual workpapers is remote at best, the Government first implies that the documents in effect constitute a summary of dishonest tax treatments: "[o]ur self-reporting tax system is premised upon the assumption that the majority of taxpayers will honestly report their income and deductions. * * * [I]f the Treasury is to * * * enforce the internal revenue laws * * *, it must have the statutory power to obtain information with respect to persons who may not have complied with the tax laws." U.S. Br. 15-16. These statements misperceive the process by which the revenue laws are interpreted and enforced, and unfairly malign the taxpayer-participants in that process.

There is no basis for questioning the good faith and honesty of either Amerada or El Paso in these proceedings. Rather, as the Fifth Circuit and Second Circuit expressly recognized, the Internal Revenue Code is not "a model of clarity," and, hence, different parties may in good faith take differing tax positions regarding the same transaction. *El Paso*, 682 F.2d at 534; *Arthur Young*, Pet. App. 29a. The process could hardly be otherwise, for, as the Fifth Circuit noted, "[t]here are many 'gray areas' in the tax world, twilight zones in which one may only dimly perceive how properly to treat a given accretion to wealth or given expenditure of funds." 682 F.2d at 534. In practice, therefore, as the Fifth Circuit held, a firm's "actual tax liability * * * is hammered out in negotiations and ultimately subject to resolution in the courts." *Id.* at 545.

There is no doubt that the "hammering out" process by which a corporation's actual tax liability is determined is an *adversary process* and that, contrary to the Government's suggestions, this process does not begin with any court adjudication that might occur. Rather, as the pertinent authorities specifically and unequivocally recognize,

the adversarial nature of a taxpayer's proceeding against the IRS begins *when the investigation of his return begins*, and continues through all the negotiations, hearings, and appeals to which the taxpayer is entitled in the administrative process: [10]

> A tax dispute is heard initially by an agency whose employees are frequently no more objective than taxpayers * * *. A tax lawyer's professional obligations must be defined, therefore, in a system that is basically adversary.[11]

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[10] In the case of large publicly-held corporations like El Paso, the IRS uniformly audits each year's return several years after its filing. If the examining agent on completing his audit believes that a deficiency exists, he will so inform the taxpayer. 3 Fed. Tax Regs. § 601.105(b)(4) (1983). The taxpayer may then either agree to pay the assessed deficiency, or seek review of the examiner's decision by the Appeals Office. 3 *id.* § 601.106(a), (b). Should an agreement be reached, the taxpayer will conclude the matter by paying the deficiency. 3 *id.* § 601.106(d)(2). At each stage of this process, negotiation and settlement of disputed issues is the goal of both sides to the proceedings. If no settlement is reached, the IRS will issue a 90-day Notice of Deficiency, giving the taxpayer that period within which to seek judicial review in the Tax Court. 3 *id.* § 601.103(c)(2). Alternatively, the taxpayer may pay the deficiency and thereafter sue for a refund in the Claims Court or in federal district court. 28 U.S.C. § 1340 (1976); 3 Fed. Tax Regs. § 601.103(c)(3). *See generally United States* v. *Baggot*, 103 S. Ct. 3164, 3166 (1983).

[11] Special Committee on Lawyer's Role in Tax Practice, The Association of the Bar of the City of New York, *The Lawyer's Role in Tax Practice*, 36 Tax Law. 865, 876 (Summer 1983) (footnote omitted). *Accord, Guidelines to Tax Practice*, ABA Section of Taxation, 31 Tax Law. 551, 558 (1977) ("[A]s an advocate before a Service which itself represents the adversary point of view, where his client's case is fairly arguable, a lawyer is under no duty to disclose its weaknesses"); Bittker, *Professional Responsibility in Federal Tax Practice* 22 (1970) ("In dealing with the Treasury the lawyer is * * * an advocate in an adversary proceeding"); Walter, *Changes in Strategic Positions Between the IRS and Tax Practitioners: Impact of the Disclosure of Information*," 58 Taxes 815, 816 (Dec. 1980) ("In the case of investigation of returns by the IRS[,] [t]he self-assessment period is over, and the roles are largely ad-

The IRS—of all parties—should be most keenly aware of the adversarial nature of the administrative tax process. This is so not only because the IRS is a constant participant in that process, but also because it has steadfastly and successfully resisted all recent efforts by taxpayers to acquire *its own* legal and investigatory preparation on the ground that disclosure would hamper its ability to present its best case during the process.[12] This

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versarial"); Bennion, *How and Where to Settle a Federal Income Tax Dispute—a Practicing Lawyer's Views*, 21 S.Cal. Inst. Fed. Tax'n 9, 10 (1969) ("[W]e have from the start what really amounts to an adversary proceeding, * * * in the sense of being in contention with or opposing the view of the examining agent. The examining agent contends that there is error in a return which the taxpayer believed and believes to be a correct return. * * * As in any adversary proceeding, the art of advocacy, of persuasion, is of prime importance"); Garbis & Frome, *Procedures in Federal Tax Controversies* 1.9 (1968) ("Establishing a case before the service is much like presenting a case to any other fact finding forum. Evidence is introduced by means of testimony or documents that support the taxpayers' conclusions"); Horowitz, *Negotiating Strategies for Effectively Settling Civil Tax Controversies with the IRS*, 22 Tax'n for Acct. 204, 205 (1979) ("Any proceeding with the IRS is an adversary proceeding"); Heintz, *How to Improve your Client's Chances of Success When the IRS Audits His Return*, 16 Tax'n for Acct. 334, 335 (1976) ("A tax dispute is in reality an adversary proceeding").

[12] *Anheuser-Busch, Inc.* v. *Internal Revenue Service*, 493 F. Supp. 549, 551 (D.D.C. 1980) (disclosure of IRS investigatory material regarding taxpayer's civil tax liability would "impair IRS' ability to present its best case both during the administrative process as well as during litigation that may result"). *Accord*, *White* v. *IRS*, 707 F.2d 897, 901-902 (6th Cir. 1983) ("untimely disclosure" of IRS analysis of taxpayer liability would impair its ability to administer tax laws; "legal research" by IRS related to future proceedings against taxpayer protected by work-product privilege); *Chamberlain* v. *Kurtz*, 589 F.2d 827, 840-841 (5th Cir.), *cert. denied*, 444 U.S. 842 (1979) (internal IRS memoranda discussing facts and law related to taxpayer's potential liability for back taxes not discoverable by taxpayer, even though information "could doubtless be of benefit to him in the preparation of his defense to the various claims against him"); *Green* v. *IRS*, 556 F. Supp. 79, 84 (N.D. Ind. 1982) (IRS documents discussing taxpayer's liability exempted from dis-

being so, we think it extraordinary that the IRS should now argue that the taxpayer does not have a similar interest in protecting its own investigatory analyses. As this Court made clear in *Hickman*, the adversary process works only when *both* sides to a legal dispute have the same protection for their work product: permissible "[d]iscovery is not a one-way proposition. It is available in *all* types of cases at the behest of *any* party * * *." 329 U.S. at 510 (emphasis added).

Thus, even if the Government were correct in its claim that *courtroom* litigation was unlikely when the tax accrual workpapers were generated [13]—a fact that is not at all clear and is not supported by the record in either case—this does not deprive the materials of work-product protection. Those materials were plainly prepared in contemplation of *near-certain* adversary proceedings with the IRS, primarily administrative, but potentially judicial; [14] their content is unquestionably of the very sort the

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closure in order to foster "frank expression" by government agents and to shield their "mental processes"); *Savoie* v. *IRS*, 544 F. Supp. 662, 666, 667 (W.D. La. 1982) (legal advice to IRS regarding administrative proceeding against taxpayer protected from disclosure by work-product doctrine); *Barger* v. *IRS*, 65 T.C. 925, 930-931 (1976) (taxpayer not entitled to IRS agents' advisory and analytical reports regarding his potential liability).

[13] *See* U.S. Reply Brief 2 n.2, *United States* v. *Baggot*, 103 S.Ct. 3164 (1983) ("a very small percentage of all cases audited by the Service result in litigation").

[14] The fact that the tax accrual workpapers may have primarily contemplated an administrative rather than a judicial proceeding is of no moment. "Adversary procedure is what the work product privilege was designed to protect," and, hence, "the privilege applies not only to litigation in courts, but to litigation before administrative tribunals * * *." *United States* v. *AT&T*, 86 F.R.D. 603, 627, 628 (D.D.C. 1980). *See, e.g., Savoie* v. *IRS*, 544 F. Supp. at 667 (work-product doctrine protects legal advice prepared for IRS administrative proceedings); *In re Natta*, 410 F.2d 187 (3d Cir.), *cert. denied*, 396 U.S. 836 (1969) (work-product doctrine protects analysis prepared for patent interference administrative proceedings).

Thus, the work-product rule is premised on very different considerations from, and has far broader applications than, Rule

work-product doctrine was designed to protect; and it is clear that the IRS would receive protection for similar materials revealing its own preparation for the proceedings.[15] We submit that taxpayers are entitled to that same protection.

C. Taxpayers Do Not Forfeit Their Work-Product Privilege By Complying With SEC Financial Reporting Requirements.

The Government's and the Fifth Circuit's second argument against application of the work-product privilege is that the tax accrual workpapers were not prepared "with an eye toward litigation," but rather to comply with SEC financial reporting requirements. U.S. Br. 33-35; *El Paso*, 682 F.2d at 542-544. This amounts to a claim that a taxpayer must forfeit all work-product protection against the IRS in order to respond in good faith to the SEC. This claim is not only manifestly unfair but contrary to settled law.

It is true, of course, that SEC reporting requirements caused Amerada and El Paso to generate the particular documents here at issue. But it does not follow that the documents are therefore not protected by the privilege. The *substance* of those documents—a candid assessment of challenges the IRS might make against the companies'

6(e)(3)(C)(i) of the Federal Rules of Criminal Procedure. That Rule permits access to grand jury materials "when so directed by a court preliminary to or in connection with a judicial proceeding." But quite unlike the work-product rule, Rule 6 is designed to protect grand jury proceedings, not the adversary process; applies only to "judicial proceedings," not to administrative litigation; and, furthermore, applies only where courtroom litigation will *necessarily* occur, not where it "may" occur or even is "likely" to occur. *See United States* v. *Baggot*, 103 S.Ct. at 3167-68. In sum, as the Government made clear in its Reply Brief in *Baggot*, the "in anticipation of litigation" rule and the "preliminary to * * * a judicial proceeding" rule have "entirely unrelated purposes," which "strongly suggest[s] that different standards" should govern their respective applications. U.S. Reply Brief at 3 n.5.

[15] *See* cases cited note 12, *supra*.

tax returns and of the legal theories and strategies by which they intended to meet those challenges in adversary proceedings with the IRS—is indisputably the parties' work product. The fact that SEC requirements compelled the parties to produce that work product in a *form* usable for purposes other than litigation does not make it any the less entitled to protection. *See FBI* v. *Abramson*, 456 U.S. 615, 631-632 (1982) (privileged information does not lose that status simply because it is produced in a new form for reasons unrelated to the privilege).

Plainly, the circumstances in these cases are that work-product information which the parties had already prepared or subsequently would have prepared for purposes of adversary tax proceedings with the IRS [16] has been

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[16] Unquestionably, the information shared with the accountants is precisely the kind of information that El Paso and all other prudent corporations gather in preparation for IRS proceedings. *See, e.g.*, Caplin, *How to Handle a Federal Income Tax Audit*, 28 Wash. & Lee L. Rev. 331, 335 (1971) ("[s]uch an early analysis will guide the taxpayer on the best procedural route to follow * * *." [I]n brief, the tax practitioner must be in a position as soon as possible to advise his client whether, and at what price, to settle his case by carefully assaying the prospects of his prevailing either administratively or in court"); Bennion, *supra*, 21 S. Cal. Inst. Fed. Tax'n at 11 ("In the final analysis, whether an issue should be settled and, if so, at what price, must be measured against * * * the prospects of sustaining the taxpayer's position in court"); Simon & Burton, *How an Attorney can Effectively Assist a Client Whose Return is Being Examined*, 6 Tax'n for Law. 240, 242 (1978) ("The first thing which a lawyer should do after getting involved in the audit of a client is to undertake a thorough investigation of the law with respect to all probable or potential issues"); Heintz, *supra*, 16 Tax'n for Acct. at 336 ("In evaluating a settlement with the IRS, * * * [a]spects to consider include * * * the strength of the taxpayer's case, and a realistic range of possible settlements * * * bear-[ing] in mind that * * * gray areas may have differing strengths and weaknesses. * * * Finally, the practitioner needs to view the realistic dollar range within which the client should be willing to settle"); A. Santa Barbara, *Internal Revenue Service Practice and Procedure* 284 (1976) ("Pending the completion of the audit, the tax manager or liaison should assess the probable success he will have in defending his position * * *. The preparation of a list of

shared with their accountants in order to satisfy SEC requirements. The only question, then, is whether that compliance constitutes a *waiver* of the privilege. The answer to that question is clearly no: it is well settled that a party's disclosure of work-product materials to a non-adverse third party (whether private or governmental) does not waive the privilege as to the party's adversary.[17] This is particularly so where, as here, disclosure to the third party was compulsory rather than voluntary.[18] Thus, we submit, El Paso's and Amerada's sharing of their work-product information with their accountants to meet SEC requirements did not waive their work-product privilege against the IRS.[19]

D. The Fact That Accountants Prepared The Tax Accrual Documents Does Not Render Them Ineligible For Work-Product Protection.

The Government's final argument is that the work-product privilege is inapplicable to documents prepared by accountants because, unlike attorneys, accountants are

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issues, the cost of each adjustment and the relative chances of success will facilitate the settlement of the issues by negotiation").

[17] *See In re Doe*, 662 F.2d 1073, 1081 (4th Cir. 1981), *cert. denied*, 455 U.S. 1000 (1982); *United States* v. *AT&T*, 642 F.2d 1285, 1299 (D.C. Cir. 1980); *GAF Corp.* v. *Eastman Kodak Co.*, 85 F.R.D. 46, 51-52 (S.D.N.Y. 1979); *cf. United States* v. *Nobles*, 422 U.S. at 239 n.14 (counsel's attempt to make affirmative *testimonial* use of contents of work-product waived the privilege).

[18] *See In re Sealed Case*, 676 F.2d 793, 817 (D.C. Cir. 1982), and cases cited therein.

[19] By urging in this brief that its workpapers are protected by the work-product privilege, El Paso does not forego its contention, raised in its petition (pp. 16-17), that those workpapers are also entitled to protection under the attorney-client privilege. Indeed, in *El Paso*, unlike *Arthur Young*, the lower court acknowledged "that a lawyer's analysis of the soft spots in a tax return and his judgments on the outcome of [the] litigation" ought ordinarily to be privileged. 682 F.2d at 539. Nevertheless, the Fifth Circuit held—contrary to the rule in other circuits (*see* Pet. 16-17)—that by discussing the contents of the workpapers with its accountant El Paso had waived its privilege. 682 F.2d at 539-541.

"independent" of their clients. Hence, says the Government, since "the very purpose of client communications to [the accountant] is to enable the accountant to exercise his discretion to disclose all relevant information to the public or public agencies," there is "no justification" for holding those communications privileged. U.S. Br. 36-37.

There are several answers to this argument. First, its factual predicate is totally inaccurate. It is true that the AICPA Code of Ethics requires accountants to maintain their "independence" in order to meet their responsibility to the public. But the Code also makes clear that this "independence" is in no way inconsistent with accountants' very specific responsibilities to their clients. ET Section 54 of the Code ("Responsibilities to Clients") provides in paragraph .01 that an accountant

> [s]hould serve his clients with competence and with professional concern for their best interests. He must not permit his regard for a client's interest, however, to override his obligation to the public to maintain his independence, integrity and objectivity. The discharge of this dual responsibility to both clients and the public requires a high degree of ethical perception and conduct.

Paragraph .02 of this Section then explains how this "dual responsibility" is exercised:

> It is fundamental that the CPA hold in strict confidence all information concerning a client's affairs which he acquires in the course of his engagement. This does not mean, however, that he should acquiesce in a client's unwillingness to make disclosures in financial reports which are necessary to fair presentation.

Thus, contrary to the Government's argument, accountants have a "fundamental" duty to keep private all information received from their clients, except where disclosure is necessary to make their public financial reports full and fair. The information which El Paso's and Amerada's accountants thought "necessary" to disclose

to the public to meet their duty of independence is, of course, already available to the IRS. What the IRS seeks now, therefore, is information whose disclosure was *not required* to meet the accountants' duty to the public and which *must* be kept confidential for accountants to meet their duty to their clients. Hence, the Government's claim that there is "no justification" for protecting this information is completely incorrect.

Moreover, the Government's argument that there can be an "attorney work-product privilege" but not an "accountant work-product privilege" misapprehends the privilege. As previously discussed (page 7, *supra*), this Court has recognized that the privilege applies not to certain occupations, but to *any* person acting on behalf of another party. Here, Arthur Young was clearly acting on behalf of Amerada when it prepared the tax accrual workpapers. And, since the other work-product requirements are met (*see* sections A, B, and C, *supra*), the privilege applies.

Furthermore, as explained above, it is incorrect to view this case as one in which the preparation of the *documents* by Arthur Young is of great moment; what matters is the preparation of the work-product *information* itself. That information was generated by Amerada, not Arthur Young,[20] and was thereafter simply shared with Arthur Young so that it could reproduce that information in another form. *Cf. FBI* v. *Abramson*, 456 U.S. at 628-629. Hence, since the sharing of the work-product information did not constitute a waiver of the privilege (*see* pp. 13-15, *supra*), the privilege is secure.

Finally, even were the Court to conclude that documents prepared by accountants are not protected by work product, that conclusion would be inapplicable to El Paso. As previously stated, El Paso's tax accrual workpapers

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[20] Obviously, the accountant is merely the *reviewer*, not the *author* of the legal strategies and candid assessments reflected in the workpapers.

were all prepared in-house under the direction of legal counsel. As this is the normal method of workpaper generation, the rule articulated by the Court should take these material facts into account.

E. The IRS Has Failed To Make A Showing Sufficient To Overcome The Work-Product Privilege Attaching To Tax Accrual Workpapers.

The only remaining question is whether the IRS has made a showing sufficient to overcome the work-product privilege. We submit that it has not. Indeed, *no showing* should suffice to overcome the privilege in this case, given the content of these workpapers. Federal Rule of Civil Procedure 26(b)(3) unqualifiedly "protect[s] against disclosure" materials constituting "the mental impressions, conclusions, opinions, or legal theories of an attorney or other representative of a party concerning litigation," and "no showing of relevance, substantial need or undue hardship" *can ever* justify disclosure of such material.[21] Since the workpapers reflect nothing but such material—opinions concerning which facts are relevant and theories concerning how best to defend on the basis of those facts—they are absolutely privileged.[22]

Moreover, even if tax accrual workpapers were deemed subject to disclosure in some cases, here the IRS has plainly not made the necessary "extraordinary showing" required to warrant such disclosure.[23] Rule 26(b)(3)

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[21] *Duplan Corp.* v. *Moulinage et Retorderie de Chavanoz*, 509 F.2d 730, 734 (4th Cir. 1974), *cert. denied*, 420 U.S. 997 (1975). *See* 8 C. Wright & A. Miller, *Federal Practice and Procedure* § 2026, at 230-231 (1970); *see also In re Grand Jury Investigation*, 599 F.2d 1224, 1231 (3d Cir. 1979) ("'opinion work product' is the most sacrosanct"); *United States* v. *Leggett & Platt, Inc.*, 542 F.2d 655, 660 (6th Cir. 1976), *cert. denied*, 430 U.S. 945 (1977).

[22] *Cf., e.g., In re Grand Jury Proceedings*, 473 F.2d 840, 848 (8th Cir. 1973) (attorney's witness statements absolutely privileged); *In re Grand Jury Investigation*, 412 F. Supp. 943, 949 (E.D. Pa. 1976) (same).

[23] *In re Sealed Case*, 676 F.2d at 810; *see Upjohn Co.*, 449 U.S. at 401-402.

prevents disclosure even of discoverable work-product material absent a showing of substantial need therefor and an inability to obtain equivalent information elsewhere "without undue hardship." [24] Furthermore, where, as in these cases, such disclosure threatens to "reveal the attorneys' mental processes in evaluating" facts, the IRS must make "a far stronger showing of necessity and unavailability by other means" than is the case in general.[25]

In an effort to make that showing, the Government makes essentially three claims. First, while conceding that "some" of the data in the workpapers may be "readily available on an ordinary audit," it contends that the workpapers "may" also contain "facts" that "may not come to the attention of the IRS during a normal audit * * *." U.S. Br. 24. If this assertion is sufficient to make the requisite showing, the privilege will be rendered a nullity. The IRS can of course claim in *every* case that there *may* be information in the workpapers that *might not* otherwise come to its attention. Indeed, speculative as this claim is,[26] it is not even an assertion that the IRS does not already have access to the information which is in the workpapers; rather, it is a statement that, although the IRS "may" already have the information, that information may not have been brought squarely "to its attention." It need hardly be said that this does not begin to meet the requirements of the Rule.[27]

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[24] *See, e.g., Grolier*, 103 S. Ct. at 2212-13; *Upjohn Co.*, 449 U.S. at 400.

[25] *Upjohn Co.*, 449 U.S. at 401, 402.

[26] The Government speculates further that there "may" be "missing" information in the workpapers which "frequently aris[es]" in "a multinational corporate tax audit." U.S. Br. 24. This speculation is completely unfounded. All such data are necessarily provided to the IRS through previously filed schedules. See the Appendix to this brief for a complete description of those schedules.

[27] The Government also suggests that it needs the workpapers to discern "the taxpayer's state of mind regarding the treatment it *ultimately presents* on its tax returns" U.S. Br. 25 (emphasis

The Government's other two claims reveal its true colors on this issue. It says, first, that it is entitled to have the documents because they "will in effect embody the taxpayer's and the accountant's judgments about which facts are *relevant* to the taxpayer's lawful liability." U.S. Br. 26 (emphasis in original). Second, the Government says that the workpapers "may also contain the accountant's—and, indirectly, the taxpayer's—*opinions and judgments about the propriety of the corporation's reporting positions and about the potentials for and strength of an IRS challenge to those positions.*" *Id.* (emphasis added). The Government is entitled to such opinions, it says, to ensure that the IRS will "discover all of the relevant facts." *Id.* at 27. We find these claims astonishing; it is as if the Government had never read *Hickman* at all. Indeed, its claims for "overcoming" the work-product privilege consist merely of proof beyond any doubt that the materials are in fact work product. And those claims make unmistakable that the Government seeks what this Court categorically forbade in *Hickman* and *Upjohn*—forcing the taxpayer to make the IRS' job "more convenient," by allowing it to perform its function ' "on wits borrowed from [its] adversary." ' *Upjohn*, 449 U.S. at 396 (quoting *Hickman*, 329 U.S. at 516 (Jackson, J., concurring)).

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added). This suggestion overlooks the fact that the workpapers are in no way associated with the preparation of tax returns (*see* Caplin, *supra*, 1 Va. Tax Rev. at 69). It also ignores the fact that both the Second Circuit in *Arthur Young* and the Fifth Circuit in *El Paso* specifically found that the IRS did not summon these papers for purposes of establishing fraud. *See Arthur Young*, Pet. App. 32a ("the IRS is not attempting to prove that Amerada is guilty of fraud * * *"); *El Paso*, 682 F.2d at 533 ("The audit of El Paso that triggered the summons in this case was not conducted on suspicion of fraud; rather, it was a routine audit occasioned by the amount of taxes at stake"). *Compare In re Sealed Case*, 676 F.2d at 813-816. Hence, in the absence of some showing that "state of mind" is relevant to the particular inquiry—a showing that was clearly not made in the present cases—this claim is no basis for overcoming the work-product privilege.

We respectfully urge the Court to conclude that the workpapers are protected by the work-product privilege and that nothing the IRS has shown is sufficient to overcome that privilege. In the event that the Court rejects this argument, we ask that the workpapers nevertheless be found privileged for the reasons stated below.

II. THE PUBLIC'S SIGNIFICANT INTERESTS IN THE FAIR, EFFICIENT OPERATION OF THE TAX ADMINISTRATIVE PROCESS AND THE SECURITIES MARKETS REQUIRE THE RECOGNITION OF A PRIVILEGE FOR TAX ACCRUAL WORKPAPERS.

A. Whether Tax Accrual Workpapers Should Be Privileged Must Be Determined By Balancing The Legitimate Competing Interests.

The Government argues (U.S. Br. 43-44) that resolution of any perceived conflict between policies underlying the securities laws and those of the revenue laws should be left to Congress. Yet in Rule 501 of the Federal Rules of Evidence Congress specifically directed "the federal courts to continue the evolutionary development of testimonial privileges * * * 'governed by the principles of the common law as they may be interpreted * * * in the light of reason and experience.'" *Trammel* v. *United States*, 445 U.S. 40, 47 (1980) (quoting Rule 501). Through that Rule, "Congress manifested an affirmative intention not to freeze the law of privilege," but to leave "the door open to change" by "'provid[ing] the courts with the flexibility to develop rules of privilege on a case-by-case basis * * *.'" 445 U.S. at 47 (citation omitted).[28] This Court's authority to adopt a privilege is therefore clear.

Furthermore, contrary to the Government's suggestion (U.S. Br. 42-43), Rule 501 does not necessitate a conflict in the requirements of federal law before the federal

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[28] *See* S. Rep. No. 1277, 93d Cong., 2d Sess. 11 (1974); H.R. Rep. No. 650, 93d Cong., 1st Sess. 8 (1973).

courts may recognize a privilege. Rather, Rule 501 directs that a balancing test, enlightened by "reason and experience," be applied to determine whether a privilege should be recognized in a particular context.[29] The test is designed to measure whether a privilege "promotes sufficiently important interests to outweigh the need for probative evidence in the administration of * * * justice." *Trammel*, 445 U.S. at 51.[30] Such a balancing test, rather than a mechanical application of a rule demanding disclosure irrespective of the consequences (as suggested by the Government, U.S. Br. 9, 15), should be applied here.[31]

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[29] *See Upjohn Co.*, 449 U.S. at 390-402; *Trammel*, 445 U.S. at 47, 51-53; J. Weinstein & M. Berger, *Weinstein's Evidence* ¶ 501[03], at 501-30 (1982). *See also* C. McCormick, *Handbook of the Law of Evidence* § 87, at 175-177 (2d ed. 1972); 8 J. Wigmore, *Evidence* § 2285, at 527 (McNaughton rev. ed. 1961).

[30] This test reflects the approach this Court has long taken in determining whether the need for full development of relevant facts outweighs any countervailing demands for confidentiality. *See, e.g., United States* v. *Ragen*, 340 U.S. 462 (1951) (government records privilege); *Roviaro* v. *United States*, 353 U.S. 53 (1957) (informer's privilege); *NLRB* v. *Sears, Roebuck & Co.*, 421 U.S. at 150-154 (intra-agency advisory opinions); *see also Funk* v. *United States*, 290 U.S. 371, 379-386 (1933) (spousal qualification).

[31] *See* J. Weinstein & M. Berger, *supra*, ¶ 501[03], at 501-31. *St. Regis Paper Co.* v. *United States*, 368 U.S. 208 (1961), relied on by the Government (U.S. Br. 43), is inapposite. The issue in *St. Regis* was whether Section 9(a) of the Census Act granted a party the right to confidentiality for information obtained by the Census Bureau, and thereby implicitly repealed the Federal Trade Commission's authority to obtain the same information. There was no question in that case whether material prepared and possessed by a private party and *not* obtained by the Census Bureau was privileged from discovery by the FTC.

Finally, the Government's argument that "a literal reading of the revenue provision plainly directs that relevant documents be produced" (U.S. Br. 44) is beside the point because, as this Court has twice recently recognized, the federal revenue laws are "subject to the traditional privileges and limitations" (*United States* v. *Euge*, 444 U.S. 707, 714 (1980)), such as the work-product privilege. *Upjohn Co.*, 449 U.S. at 398.

B. Recognition Of The Privilege Is Essential To Protect The Public's Interest In Fair, Efficient Administration Of The Nation's Tax And Securities Laws.

1. Protection of tax accrual workpapers is necessary to assure the fair and efficient enforcement of the tax laws.

The most important public interest threatened by routine disclosure of the workpapers is the fair and efficient administration of the tax laws. No matter how the IRS may choose to couch its motives for demanding these workpapers, the public perception will be that the IRS is requiring taxpayers to do its work for it, to orchestrate arguments against themselves, and to reveal their private deliberations and strategies for dealing with the IRS. Even if the Court finds such an IRS practice technically beyond the reaches of the work-product doctrine, approval of the practice will bring about precisely the results that privilege was designed to prevent.

Thus, the practice will clearly afford the IRS the opportunity "to perform its functions * * * on wits borrowed from [its] adversary." *Hickman*, 329 U.S. at 516 (Jackson, J., concurring). This will have a "demoralizing" effect on taxpayers, their attorneys, and others who assist them in proceedings against the IRS. *Id.* at 511; *see Grolier*, 103 S.Ct. at 2213 (Brennan, J., concurring). It will necessarily lessen if not destroy taxpayers' incentive to offer "thorough preparation and presentation of [their] side of the case"—which is the very goal the privilege was designed to sustain[32] and is the *sine qua non* of the adversary process.[33] The result will surely be a

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[32] *Nobles*, 422 U.S. at 238.

[33] It can hardly be disputed that the indispensable steps which taxpayers take to prepare for the tax adversary process are the same ones that forced disclosure of the workpapers will inhibit. *See, e.g.*, Bennion, *supra*, at 22 ("the most difficult task * * * is that of advising whether a dispute should be settled and, if so, at what price. * * * [T]he vast majority of issues and cases are susceptible of fair settlement, and procedures are available to encour-

deterioration of the tax adversary process: fewer cases will be negotiated and settled through the now-efficient tax administrative process; significantly more federal court litigation will necessarily ensue; and the single most important goal of the adversary process—just decision-making [34]—will be thwarted.

Nor is that all. For two reasons, the damaging repercussions of the proposed IRS practice would extend far beyond production of the kind of workpapers sought in these cases. First, it must be remembered that Section 7602 authorizes IRS not only to examine written documents, but "[t]o summon the person liable for tax * * * or any other person the Secretary may deem proper * * * to give such testimony, under oath, as may be relevant or material to" an audit. Thus, under IRS's interpretation of the statute, even in cases where tax accrual workpapers were never even compiled, the IRS could nevertheless demand that any taxpayer, his accountant, *or even his lawyer* provide the IRS with testimony providing the same type of candid appraisal as is found in tax accrual workpapers. Indeed, the summons in El Paso's own case demonstrates just how far the IRS believes its power extends. That summons commands El Paso's principal tax counsel "to appear before [the IRS], to give testimony relating to [El Paso's] tax liability * * *." [35] Under the Government's view,

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age settlements and make them possible. The best service to clients is to take full advantage of these opportunities, with the utmost diligence in preparation, presentation, analysis, and advice."); Garbis & Frome, *supra*, at 1.9 ("presentation of proof at a settlement conference or office audit should be carefully planned. Thorough preparation is critical"); Horowitz, *supra*, 22 Tax'n for Acct. at 205 ("Preparation is the catalyst to successful settlements"); Caplin, *supra*, 28 Wash. & Lee L. Rev. at 335; Heintz, *supra*, 16 Tax'n for Acct. at 336.

[34] *"The work product privilege rests on the belief that * * * promotion of adversary preparation ultimately furthers the truth-finding process." United States* v. *AT&T Co.*, 642 F.2d at 1300 (emphasis in original).

[35] Pet. App. in No. 82-716, at 66a.

therefore, El Paso's own in-house counsel can be compelled, under oath, to identify all potential weaknesses in his client's return and reveal his intended strategies and legal theories for defending those weaknesses. Such a result will completely eviscerate the work-product privilege.

Second, and equally important, granting the IRS such unlimited power poses a serious threat to our self-assessment tax system. As former Commissioner Caplin has observed, "[h]onest and evenhanded tax administration" is an indispensable element of that system. Caplin, *supra*, 28 Wash. & Lee L. Rev. at 331. The system works "because of the tremendous confidence and respect which exists between the professionals on both sides—both in the government and in the private sector." Statement of former IRS Commissioner Sheldon S. Cohen, at 1.[36] The self-assessors—the millions of taxpayers in this country—expect and demand "fair play" from the IRS. *See id.* at 2. When that "fair play" is not forthcoming, as when the IRS gives the appearance of overreaching, it "threaten[s] the breakdown of the self-assessment process." Walter, *supra*, 58 Taxes at 816. Numerous commentators have suggested[37] that the IRS practice under review poses such a threat and is, at the very least, fatally inconsistent with the IRS's announced mission to "encourage and achieve the highest possible degree of voluntary compliance with the tax laws and regulations and to maintain the highest degree of public confidence in the integrity and efficiency of the Service." *IRS Statement of Organization and Functions*, 39 Fed. Reg. 11,572 (March 29, 1974).

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[36] Hearings on S.677 and S.678, Before the Subcommittee on Improvements in Judicial Machinery, Committee on the Judiciary, 9th Cong., 1st Sess. (May 10, 1979).

[37] *See, e.g.*, Caplin, *supra*, 1 Va. Tax Rev. at 82-83; Walter, *supra*, 58 Taxes at 823-824; Buchholz, *Tax Accrual File Controversy: Legal Problems Facing the Accountant*, 40 N.Y.U. Inst. on Fed. Tax'n 37-1, 37-20 (1982); Note, *A Balancing Approach to the Discoverability of Accountants' Tax Liability Under Section 7602 of the Internal Revenue Code*, 60 Wash. U.L.Q. 185, 207-209 (1982); Comment, 36 Tax Law. 835, 849-850 (1983).

In summary, we submit that a "victory" by the IRS in this case would be at odds with its mission, incompatible with the tax adversary process, and highly injurious to the public interest in fair and efficient administration of the tax laws.

2. Disclosure of tax accrual workpapers would compromise the federal securities law policy of full disclosure of all material information.

Requiring disclosure of the tax accrual workpapers will lead to another damaging consequence: disruption of the free flow of material information to the investing public and lessened public confidence in the financial information it receives. As the *Arthur Young* court found, "[g]iving the complete latitude to the summons power that the IRS seeks here compromises the procedure designed by Congress to protect the investing public from inaccurate financial information." Pet. App. 31a. Such a compromise will inevitably occur because "a prudent organization might not be perfectly candid with independent auditors once it knew that the information revealed would be reachable under § 7602." Pet. App. 30a (footnote omitted).

The Government makes two arguments in response. First, it argues that the predicted lack of candor is completely speculative. U.S. Br. 39-40 & n.24. Second, it contends that the reporting requirements of the securities laws and an accountant's public duty to withhold certification of false, incomplete, or misleading financial statements will themselves guarantee full disclosure. U.S. Br. 40-42. These arguments are unsound.

First, three different Commissioners of the IRS, including current Commissioner Egger, have acknowledged that IRS's demands for the workpapers threaten the public's interest in full disclosure by making that disclosure less likely. Specifically, the Commissioners have recognized that the IRS's demands are "driving a wedge between

CPAs and their clients,"[38] cutting off the flow of tax accrual information to independent auditors, and thereby threatening the interest in full disclosure. *See* IRS News Release, IR 81-49, Remarks of Roscoe L. Egger, at 3; Caplin, *supra*, 1 Va. Tax Rev. at 81-82; Kurtz, *et al.*, *Discussion on "Questionable Positions,"* 32 Tax Law. 13, 14 (1978).[39] The unanimous opinion of these experts plainly refutes the Government's assertion that the conclusion of the court below was speculative.

Second, as the *Arthur Young* court recognized, this Court's decision in *Upjohn Co.* provides "[t]he full answer" (Pet. App. 30a n.9) to the Government's contention that complete disclosure will necessarily be forthcoming because of the reporting requirements of the securities laws and an auditor's duty accurately to describe a firm's financial status. In *Upjohn Co.*, this Court rejected an identical Government argument concerning the attorney-client privilege, stating that "*the depth and quality* of any investigations to ensure compliance with the law would suffer, even were they undertaken." 449 U.S. at 393 n.2 (emphasis added). The Court also noted that the Government's contention failed to recognize the social value in facilitating communications with counsel even where a party was attempting to comply with the law. *Id.* Those principles are equally-applicable here: protecting tax accrual workpapers will assure that complete information is given to an auditor, rather than simply the minimum necessary to comply with the securities laws. Through such assurance, the public's interest will be far better served than where a firm discloses only the barest, albeit legally sufficient, degree of information.

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[38] IRS News Release, IR 81-49, Remarks by Roscoe L. Egger before the San Francisco Chapter of the California Institute of Certified Public Accountants and the Tax Section, San Francisco Bar Association, at 3 (May 5, 1981).

[39] The available practical evidence supports these statements. *See* Buchholz, *supra*, 40 N.Y.U. Inst. on Fed. Tax'n at 37-1, 37-14, 37-16.

We submit, therefore, that the widely-recognized threat to the national interest in the efficient operation of the securities markets created by IRS's position is in no way speculative, and is not likely to be blunted for any reason the Government has suggested.

C. The IRS Has Demonstrated Slight, If Any, Legitimate Interest In Obtaining Tax Accrual Workpapers.

Balanced against these threats to the fair, efficient administration of the tax laws and to the free flow of information to investors, the IRS has shown slight, if any, legitimate interest in obtaining tax accrual workpapers. Thus, there has been no serious claim made in these cases that any specific factual information necessary to the IRS investigation of Amerada and El Paso can be expected to be found in those companies' tax accrual workpayers. Nor is there any dispute that the IRS is empowered to summon all the relevant factual information it needs—outside of the workpapers—to complete a full investigation of those companies' returns. The only real issue is whether the IRS has shown a significant, legitimate interest in acquiring *the taxpayer's opinions* concerning the relevant factual information. We submit that it has not.

IRS's long-established ability to enforce the revenue laws without resort to these workpapers refutes any claim that they are essential to that objective. Corporations have been subject to tax accrual audits since the enactment of the Securities Exchange Act of 1934, and the IRS's capability for decades since then to conduct a complete factual investigation without relying upon these workpapers betrays any latter-day claim of need. *Cf. Bankamerica Corp.* v. *United States*, 103 S.Ct. 2266, 2271-73 (1983).

Moreover, notwithstanding repeated requests from the IRS to *require* taxpayers to identify all questionable posi-

tions on their returns,[40] Congress has consistently refused to strike the balance in the IRS's favor. Indeed, in § 323(a) of the Tax Equity and Fiscal Responsibility Act of 1982—the provision of the Code most directly related to the interest the IRS claims here—Congress for the first time enacted a provision which *encourages* disclosure of positions for which the taxpayer does not have substantial authority. This provision is of course pointless if the IRS has all along had the authority to *demand* that taxpayers make such disclosure.[41] Indeed, any claim that Congress intended for the IRS to have access to such information on demand is answered by the Report of the Senate Finance Committee, which added the new disclosure provision to the 1982 Act:

> The Committee Bill provides broad regulatory authority to permit the Secretary to prescribe the form of disclosure. *However, the Committee intends that the Secretary shall in no event require disclosure of accountant's workpapers.*[42]

On balance, therefore, we submit that the public's interest in fair, efficient operation of the tax and securities laws outweighs any legitimate interest the IRS may have

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[40] *See, e.g.*, Kurtz *et al.*, *supra*, 32 Tax Law. at 15-16; Cooper, *A Tale of Tax Planning, Tax Ethics, and Tax Reform*, 80 Colum. L. Rev. 1553, 1612 (1980).

[41] The cited provision imposes a penalty for substantial underpayment of tax, but forgives the penalty with respect to items as to which "the taxpayer discloses *facts* sufficient to enable the [IRS] to identify the potential controversy, if it analyzed that information" (S. Rep. No. 494, 97th Cong., 2d Sess. 274 (1982) (emphasis added)), or for which the taxpayer has "substantial authority." H.R. Rep. No. 760, 97th Cong., 2d Sess. 575 (1982); *see* Special Committee, *supra*, 36 Tax Law. at 869.

[42] S. Rep. No. 494, 97th Cong., 2d Sess. 274 (1982) (emphasis added). *Accord*, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982, prepared by the Staff of the Joint Committee on Taxation, December 31, 1982, at 218 ("In no event, however, may such regulations require disclosure of attorney or accountant's work-papers").

in forcing disclosure of tax accrual workpapers. This justifies the privilege for the workpapers recognized by the court below.

CONCLUSION

For the foregoing reasons, the judgment of the Second Circuit in *Arthur Young* should be affirmed and the judgment of the Fifth Circuit in *El Paso* should be reversed.

Respectfully submitted,

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APPENDIX

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Until 1983 the IRS required completion of the following forms for reporting foreign income, assets, and activities of U.S. taxpayers:

(1) Form 926, "Return by a Transferor of Property to a Foreign Corporation, Foreign Estate or Trust, or Foreign Partnership" (I.R.C. § 1491);

(2) Form 957, "United States Information Return by an Officer, Director, or U.S. Shareholder of a Foreign Personal Holding Company" (I.R.C. § 6035);

(3) Form 958, "U.S. Annual Information Return by an Officer or Director of a Foreign Personal Holding Company" (I.R.C. § 6035);

(4) Form 959, "Return by an Officer, Director or Shareholder With Respect to the Organization or Reorganization of a Foreign Corporation and Acquisition of its Stock" (I.R.C. § 6046);

(5) Form 2952, "Information Return with Respect to Controlled Foreign Corporations" (I.R.C. § 6038);

(6) Form 3520, "United States Information Return—Creation of or Transfers to Certain Foreign Trusts" (I.R.C. § 6048(a));

(7) Form 3520-A, "Annual Return of Foreign Trust With U.S. Beneficiaries" (I.R.C. § 6048(c)); and

(8) Form 3646, "Income from Controlled Foreign Corporation" (I.R.C. § 951 through 971).

The IRS claims (U.S. Br. 24) that it lacks the information as to the business activities of a foreign subsidiary of a domestic corporation, which is necessary to determine the need for any re-allocation of income or deductions between the two corporations or to determine the existence of Subpart F (I.R.C. §§ 951 *et seq.*) income

arising out of the foreign subsidiary's business operations. This assertion is simply belied by the intricate taxpayer reporting system outlined above, enforced by stiff statutory penalties, including substantial fines and significant loss of tax benefits. For example, Form 2952 ("Information Return with Respect to Controlled Foreign Corporations") implements the statutory requirement in I.R.C. § 6038(a) by requiring a U.S. corporation to furnish, on an annual basis, the following detailed information with respect to a foreign corporation under its control: (1) the name, principal place of business, and nature of business of the foreign corporation; (2) current and accumulated earnings and profits of the foreign corporation; (3) an annual profit and loss statement and a balance sheet which lists assets, liabilities, and capital of the foreign corporation; (4) transactions (by amount and type) between the controlled foreign corporation and the U.S. parent, any affiliate of the parent, or any affiliate of the foreign subsidiary; and (5) a description of the various classes of stock outstanding of the foreign corporation, and a list of the names, addresses, and holdings of each U.S. shareholder who, at any time during the year, owns 5 percent or more of the stock of the foreign corporation. *See* I.R.C. § 6038(a). The Internal Revenue Manual itself advises IRS accountants that "[i]n addition to balance sheets and profit and loss statements [which are provided by the taxpayer as standard practice in an I.R.S. audit], Form 2952 (Information Return with Respect to Controlled Foreign Corporations) is a prime source of information for intercompany transactions" between a U.S. parent and its foreign subsidiaries. I *Internal Revenue Manual (Audit)* (CCH) § 4233, ¶ 523.5, at 7281-63 (1981).

Indeed, such a plethora of IRS reporting forms existed with respect to international transactions and foreign income and assets of U.S. corporations that the IRS, following the enactment of TEFRA, undertook to consolidate Forms 957, 958, 959, 2952, and 3646 into a single new multi-

purpose, multi-schedule Form 5471 (Information Return With Respect to a Foreign Corporation—January 1982). TEFRA also enacted a new I.R.C. § 6038A, imposing substantial reporting requirements on any domestic or foreign corporation engaged in business activities in the United States that is controlled by a foreign person. These extensive reporting requirements are similar to those imposed by section 6038 on U.S. parents of foreign subsidiaries. Similar reporting requirements are imposed on foreign partnerships having U.S. partners and upon U.S. persons who are partners in such a foreign partnership. *See* I.R.C. §§ 6031, 6046A.

Thus, the IRS plainly has statutory authority, under a variety of Internal Revenue Code provisions, to require a taxpayer to submit complete reports with respect to its international transactions.

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No. 82-687

IN THE
Supreme Court of the United States
OCTOBER TERM, 1982

UNITED STATES OF AMERICA,
Petitioner,
v.
ARTHUR YOUNG & COMPANY, *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS AMICUS CURIAE IN SUPPORT OF RESPONDENTS

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MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE ON BEHALF OF TAX EXECUTIVES INSTITUTE, INC. IN SUPPORT OF RESPONDENTS

To the Honorable Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

Pursuant to Rule 36 of the Rules of this Court, Tax Executives Institute, Inc. respectfully moves the Court for leave to file the accompanying brief in support of Respondents in this case as *amicus curiae*. Tax Executives Institute has requested the written consent of all parties to the filing of the accompanying brief. Petitioner has consented to the filing of the brief, but Respondents have not responded to the request for consent.*

1. Tax Executives Institute, Inc. (TEI) is a voluntary, nonprofit association of corporate and other business executives who are responsible for the tax affairs of their

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* Petitioner's written consent is filed herewith. Respondents have neither denied nor granted Tax Executives Institute's request for written consent to file the accompanying brief. If such consent is subsequently received, it shall promptly be filed with the Court.

employers. The Institute was organized in 1944 and currently has approximately 3,800 members who represent more than 1,100 of the leading corporations in the United States and Canada. TEI members represent a cross-section of the business community, and the Institute is dedicated to promoting the uniform and equitable enforcement of the tax laws throughout the nation and to reducing the costs and burdens of tax administration and compliance to the benefit of both government and taxpayers. Among the standards of professional conduct that all TEI members subscribe to is the following, which bears directly on the issue before the Court in this case:

> [The member] will present the facts required in the tax returns and all the facts pertinent to the resolution of questions at issue with representatives of the government imposing the tax.

TEI Standards of Conduct, *reprinted in* Tax Executives Institute, Inc., *Thirty Years for the Profession* 25 (1974).

2. TEI members have a vital interest in the resolution of the tax accrual workpapers issue before the Court. Substantially all TEI members are employed by corporations that are subject to federal securities laws, compliance with which requires the preparation of tax accrual workpapers or similar documents. Consequently, TEI members are almost without exception involved in the preparation or review of tax accrual workpapers. TEI is understandably concerned about the Internal Revenue Service's attempts to obtain such workpapers, which are nonfactual in nature and consist principally of theories, hypotheses, opinions, and speculations regarding contingent tax liabilities (ranging from the probable to the highly remote). In particular, TEI believes that, absent appropriate guidance from the Court on the scope of section 7602 of the Internal Revenue Code of 1954, as amended (26 U.S.C. § 7602) in respect of such tax accrual workpapers, the protections afforded taxpayers by section 7604 of the Code (26 U.S.C. § 7604) and elabo-

rated on by the Court in *United States v. Powell*, 379 U.S. 48 (1964), and its progeny could be significantly eroded and, moreover, that important policies underlying the federal securities laws (specifically, the maintenance of fair and honest securities markets) could be seriously undermined.

3. As the principal association of corporate tax executives, Tax Executives Institute is acutely aware of the need for guidance from the Court to end the uncertainty that the inconsistent and sometimes contradictory decisions of the courts of appeals for the various circuits have caused. TEI submits, moreover, that given its dedication to the corporate tax function, its participation in the case will provide an additional, broader perspective that may prove valuable to the Court in balancing the competing policy interests involved and thereby assist the Court in providing meaningful guidance to both taxpayers and the Internal Revenue Service on the scope of the Service's summons power under section 7602. In addition, the granting of this motion, which will facilitate a more thorough analysis of the tax accrual workpapers issue, will not cause any harm or prejudice to any other party.

WHEREFORE, it is respectfully requested that Tax Executives Institute's motion for leave to file the accompanying brief *amicus curiae* in support of the Repondents in this case be granted.

Respectfully submitted,

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Tax Executives Institute, Inc., *Thirty Years for the Profession* (1974) 2

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

No. 82-687

UNITED STATES OF AMERICA,
Petitioner,

v.

ARTHUR YOUNG & COMPANY, *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS AMICUS CURIAE IN SUPPORT OF RESPONDENTS

INTEREST OF THE AMICUS CURIAE

Pursuant to Rule 36 of the Rules of this Court, Tax Executives Institute, Inc. (TEI) respectfully submits this brief as *amicus curiae* to urge the Court to affirm the decision of the United States Court of Appeals for the Second Circuit, holding that an internal revenue summons issued for accountant tax accrual workpapers will not, absent allegations of fraud, be enforced. TEI is a voluntary, nonprofit association of corporate and other business executives who are responsible for the tax affairs of their employers. The Institute was organized in 1944 and currently has approximately 3,800 members who represent more than 1,100 of the leading corporations in the United States and Canada. TEI is dedicated to promoting the

uniform and equitable enforcement of tax laws throughout the nation and to reducing the costs and burdens of administration and compliance to the benefit of both the government and taxpayers. Among the standards of professional conduct that all TEI members subscribe to is the following, which bears directly on the issue before the Court in this case:

> [The member] will present the facts required in tax returns and all the facts pertinent to the resolution of questions at issue with representatives of the government imposing the tax.

TEI Standards of Conduct, *reprinted in* Tax Executives Institute, Inc., *Thirty Years for the Profession* 25 (1974).

TEI members have a vital interest in the resolution of the tax accrual workpapers issue before the Court. Substantially all TEI members are employed by corporations that are subject to federal securities laws, compliance with which requires the preparation of tax accrual workpapers or similar documents. Consequently, TEI members almost without exception are involved in the preparation or review of tax accrual workpapers.

TEI is understandably concerned about the Internal Revenue Service's attempts to obtain such workpapers, which are principally nonfactual in nature and consist of theories, hypotheses, opinions, and speculations regarding contingent tax liabilities. In particular, TEI believes that, unless appropriate guidance is forthcoming from the Court on the scope of section 7602 of the Internal Revenue Code of 1954, as amended,[1] in respect of such tax accrual workpapers, the protections from arbitrary exercises of the summons power afforded taxpayers by section 7604 of

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[1] Unless otherwise noted, all references to sections are to the Internal Revenue Code of 1954, as amended (I.R.C.), which is codified at title 26 of the United States Code.

the Code and elaborated on by this Court in *United States v. Powell*, 379 U.S. 48 (1964), and its progeny could be significantly eroded. Equally important, unless the proper balance between the competing interests is struck, important policies underlying the federal securities laws (specifically, the maintenance of fair and honest securities markets), as well as the integrity in the self assessment tax system, could be seriously undermined.

As the principal association of corporate tax executives, *amicus* Tax Executives Institute respectfully recommends that the Court not only affirm the decision of the court below but also clarify that court's holding, thereby providing meaningful guidance to taxpayers and the Internal Revenue Service alike on the scope of the Service's summons power under section 7602.

SUMMARY OF ARGUMENT

A. The Internal Revenue Service's authority under section 7602 of the Internal Revenue Code is undeniably broad, but it is not unfettered. Indeed, section 7604 of the Code imposes upon the federal courts the duty to ensure that the Service's exercise of the summons power is "kept within its proper bounds." *United States v. Bisceglia*, 420 U.S. 141, 151 (1975); *accord United States v. Powell*, 379 U.S. 48, 58 (1964). In refusing to enforce an internal revenue summons for tax accrual workpapers, the court below properly found that "substantial countervailing policies" (*United States v. Euge*, 444 U.S. 707, 711, 715-16 (1980)) under the securities laws as well as concern about the integrity of the self assessment tax system required it to invoke the work-product doctrine to protect the documents from compelled disclosure. 677 F.2d 211, 219 (2d Cir. 1982), *citing Hickman v. Taylor*, 329 U.S. 495 (1947).

The policy question raised by this case is whether essentially nonfactual documents prepared to ensure compli-

ance with federal securities laws and not in connection with the preparation of tax returns should, absent allegations of fraud or a showing of substantial need, be subject to production under section 7602. This question cannot be properly answered by just addressing, seriatim, the discrete questions of relevance, privilege, work-product, and public policy. Rather, it demands a thoughtful balancing of the different and sometimes conflicting interests involved—specifically, the Government's interest in the expeditious collection of revenue, *see Couch v. United States*, 409 U.S. 322, 336 (1973), and the "national public interest * * * [in] insur[ing] the maintenance of fair and honest markets in [securities] transactions," 15 U.S.C. § 78b (1976). Given the questionable relevance of tax accrual workpapers to a determination of tax liability, the Service's attenuated need for the workpapers, and perhaps most important, the presence of countervailing national policies relating to both the federal securities laws and the integrity of the tax system, the result of that weighing in the instant case is clear: an internal revenue summons for tax accrual workpapers should ordinarily not be enforced.

B. Before a summons can be enforced under section 7604, the Service must demonstrate that the summoned materials "may be relevant" to a determination of tax liability. *See United States v. Powell*, 379 U.S. at 57-58. The use of the words "may be" in the statute, however, does not afford the Service the right to discover "the *post-return* 'private thoughts and theories of the taxpayer' * * *." *United States v. El Paso Co.*, 682 F.2d 530, 546 (5th Cir. 1982) (Garwood, J., dissenting) (emphasis in original), *petition for cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716). The Service must still establish that the information sought by the summons is potentially relevant. Thus, although the threshold for relevance under section 7602 is low, a threshold does exist.

The Government argues tax accrual workpapers are relevant because they "might throw light" on the correctness of the taxpayer's returns. *See Foster v. United States*, 265 F.2d 183, 187 (2d Cir.), *cert. denied*, 360 U.S. 912 (1959). The "might throw light" standard, however, has never been sanctioned by the Court. Nor should it be, for it grants to the Service veritable *carte blanche*. *United States v. Coopers & Lybrand*, 550 F.2d 615, 619 (10th Cir. 1977); *United States v. Matras*, 487 U.S. 1271, 1275 (8th Cir. 1973); *accord United States v. El Paso Co.*, 682 F.2d at 547 (Garwood, J., dissenting). Rather, the Court should hold that a summons will not be enforced unless there is "an indication of a realistic expectation rather than an idle hope that something may be discovered." *United States v. Harrington*, 388 F.2d 520, 524 (2d Cir. 1968). Application of such a standard in the instant case, which involves documents that are essentially nonfactual in nature, would not only lead to an affirmance of the court below, but would vivify the protections afforded by section 7604.

C. Although concluding that tax accrual workpapers satisfy section 7602's relevance requirement, the court below properly concluded that the Service's summons should not be enforced on policy grounds. Specifically, the court held that the national policies underlying the federal securities laws required it apply the work-product doctrine to shield tax accrual workpapers from compelled disclosure. 677 F.2d at 221, *citing Hickman v. Taylor*, 329 U.S. at 512-13; *see United States v. Euge*, 444 U.S. at 711, 715-16.

The potential adverse effect on the integrity of the financial accounting process of the compelled disclosure of tax accrual workpapers cannot be ignored. Indeed, the Justice Department's Advisory Committee on Tax Litigation has stated that there are "strong policy reasons" for not examining tax accrual workpapers, and the Internal Revenue Service has likewise acknowledged "the potential for serious negative effects on the quality of financial

reporting." Report of the Justice Department Advisory Committee on Tax Litigation, *Standards for Seeking Accountant's Tax Accrual Workpapers* (May 1980); Internal Revenue News Release, IR-81-49, Remarks by Roscoe L. Egger, Jr., Commissioner of Internal Revenue, Before the Joint Meeting of the San Francisco Chapter of the California CPA Society and the Tax Section, San Francisco Bar Association, San Francisco, California, May 5, 1981 (*reprinted at* [1981] 10 Stand. Fed. Tax Rep. ¶ 6598). Thus, it is not enough to say that there are independent reasons for corporations to make full and adequate disclosures to their independent accountants and that application of the work-product doctrine is unnecessary. As the Court stated in *Upjohn Co. v. United States*, 449 U.S. 383 (1981), where a similar argument was advanced, "the depth and quality of *any* investigations to ensure compliance with the law would suffer" unless the courts, applying the rationale of *Hickman v. Taylor*, interceded. 449 U.S. at 392-93 & n.2 (emphasis added). Application of the work-product doctrine to tax accrual workpapers is necessary if independent accountants are to serve, as Congress intended, as effective instruments of public oversight.

Nor is reversal of the court below required by the Court's decision in *Couch v. United States*, *supra*. That case, which was decided before enactment of Rule 501 of the Federal Rule of Evidence, not only involved allegations of fraud and possible criminal violations but also concerned the Service's right to obtain documents used in preparing the taxpayer's returns. Thus, affirming the court below would not require recognition of a broad accountant-client privilege which was the issue in *Couch*, but rather the application of the work-product doctrine to a narrow set of documents.

D. Section 6661 of the Code, which was enacted after the court below rendered its decision, circumscribes and arguably vitiates entirely the Service's authority to ob-

tain tax accrual workpapers under section 7602. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324, 613, § 323(a). That provision imposes a penalty for the substantial understatement of tax, but the penalty will not be imposed to the extent that understatement is attributable to items the relevant facts with respect to which are disclosed on the return. Thus, Congress has passed legislation that requires, in order to avoid a penalty, the disclosure of relevant facts relating to positions for which the taxpayer does not have substantial authority.

In concluding that tax accrual workpapers should be protected from compelled disclosure, the court below referred to a provision such as section 6661 (which at the time was being considered by Congress) and essentially invited Congress to act if it concluded the court's decision was too broad. 677 F.2d at 221. Almost in response to that invitation, section 6661 was enacted. The legislative history of the provision confirms the link between section 6661 and the Service's authority under section 7602. Specifically, the Senate Report on the 1982 Act states that, although the Service's authority to prescribe the form of disclosure under section 6661 was intended to be broad, "*the Secretary shall in no event require the disclosure of accountant's work papers.*" S. Rep. No. 97-494, 97th Cong., 2d Sess. 274 (1982) (emphasis added).

Section 6661 carefully prescribes what the taxpayer should disclose (the relevant facts pertaining to positions for which there is not substantial authority) and the consequences for not doing so (the substantial understatement penalty). To enforce a summons for tax accrual workpapers, especially given the legislative history of section 6661, would be fundamentally at odds with Congress's intent.

ARGUMENT

ABSENT ALLEGATIONS OF FRAUD OR A SHOWING OF SUBSTANTIAL NEED, TAX ACCRUAL WORKPAPERS PREPARED IN THE COURSE OF REGULAR FINANCIAL AUDITS AND NOT IN CONNECTION WITH THE PREPARATION AND FILING OF TAX RETURNS SHOULD NOT BE SUBJECT TO PRODUCTION UNDER SECTION 7602 OF THE INTERNAL REVENUE CODE

A. Resolution of the Tax Accrual Workpapers Issue Requires a Balancing of the Substantial National Policies Underlying the Federal Securities Laws and the Internal Revenue Service's Purported Need for Such Workpapers to Determine Tax Liability.

Nearly two decades ago this Court was called upon to articulate the requirements for enforcement of an internal revenue summons issued under section 7602 of the Internal Revenue Code. In *United States v. Powell*, 379 U.S. 48 (1964), the Court answered that call and held that in order for such a summons to be enforced—

> [The Internal Revenue Service] must show that the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, that the information sought is not already within the Commissioner's possession, and that the administrative steps required by the Code have been followed * * *.

Id. at 57-58. In addition, the Court in *Powell* made it clear that section 7602 is not self-executing and that the federal courts have an important role to play in ensuring that the Service exercises its summons authority in good faith. *Id.* at 58. *See also United States v. Bisceglia*, 420 U.S. 141, 151 (1975) (the Internal Revenue Service's summons power "is a limited power, and should be kept within its proper bounds").[2]

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[2] In *Bisceglia* this Court explained that the purpose of section 7604 is to provide "protection from arbitrary and capricious action

The Court granted certiorari in *Powell* "[b]ecause of the differing views in the circuits on the standards the Internal Revenue Service must meet to obtain judicial enforcement of its orders * * *." 379 U.S. at 50-51 (footnote omitted). Unfortunately, with respect to tax accrual workpapers and similar documents, the uncertainty the Court sought to dispel in *Powell* remains. The continuing uncertainty is attributable in large measure to the special nature of tax accrual workpapers. Unlike the documents at issue in *Powell* and numerous other summons cases, tax accrual workpapers are essentially nonfactual in nature. They contain a company's theories, opinions, arguments, and speculations about its contingent tax liabilities. The workpapers, moreover, are not prepared in connection with the preparation of the company's tax returns. Rather, they are prepared, either by the company's own tax personnel or by independent outside accountants, to assist the company in satisfying its legal responsibilities under federal securities laws.[3]

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by placing the federal courts between the Government and the person summoned." *Id.*; *accord United States v. Harrington*, 388 F.2d 520, 523 (2d Cir. 1968) ("[t]he Government may not exercise its investigative and inquisitorial power without limit * * *").

[3] Specifically, tax accrual workpapers, which are variously referred to as "tax pool analysis," "tax accrual files," "tax cushion," and "tax liability contingency analysis," are used by the company's accountants in auditing financial statements in accordance with generally accepted accounting principles. Those principles require, among other things, that provision be made for material contingent liabilities (ranging from the probable to the highly remote), including tax liabilities that might be reasonably incurred in negotiating settlements of proposed audit adjustments to avoid extended litigation. *See* 15 U.S.C. § 78*l* (1976); Regulation S-X, 17 C.F.R. §§ 210, *et seq.* (1982). *See also* Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 5: Accounting for Contingencies* (1975), *reprinted in* Financial Accounting Standards Board, *Financial Accounting Standards* 732, *et seq.* (1977); W. Meigs, O. Whittington & R. Meigs, *Principles of Auditing* 539 (7th ed. 1982) (discussing auditor's role in planning for contingent tax liabilities).

Because tax accrual workpapers contain essentially nonfactual information and because they are prepared to ensure compliance with the federal securities laws, in determining whether to enforce a summons for such workpapers, several questions must be considered: Are tax accrual workpapers "relevant" to a determination of tax liability within the meaning of section 7602? How attenuated is the Internal Revenue Service's "need" for the workpapers inasmuch as the only facts they contain are almost without question otherwise available to the Service? Assuming, *arguendo*, that tax accrual workpapers may be potentially "relevant," do the public policies underlying the federal securities laws and considerations of fair play in the tax system require that, absent allegations of fraud or a showing of substantial need, a summons for such workpapers not be enforced?

The courts of appeals have taken different approaches to these questions and, regrettably, have come to different conclusions, not only on the result that should obtain when a summons is issued for tax accrual workpapers but also on the rationale that should be employed in determining whether to enforce such a summons. The court below concluded that, although tax accrual workpapers may be potentially relevant within the meaning of section 7602 of the Code, public policy requires that a summons for such workpapers ordinarily not be enforced; accordingly, it fashioned a work-product privilege that, in the absence of allegations of fraud, will shield the documents from compelled disclosure. 677 F.2d 211, 220-21 (2d Cir. 1982). Taking a different approach, the Tenth Circuit in *United States v. Coopers & Lybrand*, 550 F.2d 615 (10th Cir. 1977), held that a summons seeking access to tax accrual workpapers is not enforceable under section 7604 because those documents are not relevant to the taxpayer's tax liability.[4] Although taking different paths,

[4] The Eighth Circuit in *United States v. Matras*, 487 F.2d 1271 (8th Cir. 1973), reached the same result in respect of quite analogous documents. *See infra* pp. 15-16.

the Second Circuit below and the Tenth Circuit in *Coopers & Lybrand* arrived at the same result: after balancing the interests involved, both courts concluded that an internal revenue summons for tax accrual workpapers should generally not be enforced under section 7604.

In contrast, the Fifth Circuit in *United States v. El Paso Co.*, 682 F.2d 530 (5th Cir. 1982), *petition for cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716), refused to limit the Service's power to compel disclosure of tax accrual workpapers.[5] It is respectfully submitted, however, that the Fifth Circuit in *El Paso* misapprehended the federal courts' duty under section 7604 to ensure that the Service's summons power is "kept within its proper bounds." *United States v. Bisceglia*, *supra*, 420 U.S. at 151. The court similarly accorded far too little weight to the "substantial countervailing policies" and the "contrary legislative purposes" that this Court has stated must be considered in determining whether the Service's authority under section 7602 should be limited. *United States v. Euge*, 444 U.S. 707, 711, 715-16 (1980).

What is required in resolving the tax accrual workpapers issue is a thoughtful balancing of the different and sometimes competing interests involved—specifically, the Government's interest "in the enforcement of its laws and collection of the revenues," *Couch v. United States*, 409 U.S. 322, 336 (1973), and the "national public interest * * * [in] insur[ing] the maintenance of fair and

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[5] Specifically, the Fifth Circuit held that tax accrual workpapers may be relevant to the Service's audit, that the work-product doctrine had no application to such documents, and that the public policies underlying the securities laws did not limit the Service's broad authority to conduct tax investigations; the court also held that any attorney-client privilege that might have existed with respect to tax accrual workpapers prepared under the supervision of an attorney was waived when the workpapers were disclosed to the taxpayer's accountants. 682 F.2d at 545.

honest markets in [securities] transactions," 15 U.S.C. § 78b (1976). *See United States v. Arthur Young & Co.*, 677 F.2d at 219 (courts must "balance strong public policies against a party's need for information whenever a conflict between the two arises"), *citing Hickman v. Taylor*, 329 U.S. 495 (1947).

When striking this balance, moreover, resort should not be made to shibboleths or semantics. Section 7604 requires more than the myopic application of mechanical tests. The policy question raised by this case is whether essentially nonfactual documents prepared to ensure compliance with the securities laws and not in connection with preparation of tax returns should, absent allegations of fraud or a showing of substantial need, be subject to a summons issued under section 7602 of the Code. That question cannot be answered properly just by addressing, seriatim, the discrete questions of relevance, privilege, work-product, and public policy. Rather, the whole of the matter must be considered, and *amicus* Tax Executives Institute respectfully submits that the whole—the combination of tax accrual workpapers' questionable relevance, the Internal Revenue Service's attenuated need for such workpapers, and the presence of countervailing national policies (relating to both the federal securities laws and the integrity of the tax system)—should lead the Court to hold that a summons for tax accrual workpapers shall ordinarily not be enforced. Consequently, the decision of the court below should be affirmed.

B. Tax Accrual Workpapers Are At Best Only Marginally Relevant to the Determination of Tax Liability.

The court below held that tax accrual workpapers are potentially relevant to the Internal Revenue Service's audit, and although the court properly concluded on other grounds that a summons for such workpapers should not be enforced absent allegations of fraud, its holding on the relevance question is squarely at odds with the Tenth

Circuit's decision in *Coopers & Lybrand*, *supra*, and with the reasoning of the Eighth Circuit in *United States v. Matras*, 487 F.2d 1271 (8th Cir. 1973). In affirming the Second Circuit's decision, the Court should hold that the determination of relevance in itself requires a weighing of the different interests involved and, consequently, that tax accrual workpapers will rarely if ever be relevant under section 7602.

In deciding the relevance issue, the court below applied the test it first articulated in *Foster v. United States*, 265 F.2d 183 (2d Cir.), *cert. denied*, 360 U.S. 912 (1959), namely, that a summons will satisfy the relevance test if the information sought "might have thrown light" upon the correctness of the taxpayer's returns. 265 F.2d at 187; *United States v. Arthur Young & Co.*, 677 F.2d at 218. Although acknowledging the tax accrual workpapers are not prepared to assist in filling out tax returns but rather only for financial reporting purposes, the court concluded that the documents are relevant because "[i]t is difficult to say that the assessment by the independent auditor of the correctness of positions taken by the taxpayer in his return would not throw 'light upon' the correctness of the return." *Id.* at 219; *see United States v. El Paso Co.*, 682 F.2d at 537 (holding tax accrual workpapers relevant because they tend to "focus and concentrate the Service's energy on questionable positions in the return * * *"). Concededly, the threshold for relevance under section 7602 is low, but a threshold does exist. The flaw in the "might throw light" standard employed by the court below is that it ignores the courts' role in ensuring that the threshold is indeed met and thereby grants the Service veritable *carte blanche*.

In its brief on the merits, the Government fully supports the "might throw light" standard and embraces the Second Circuit's discussion of the relevance issue.

After reviewing at length the general scope of the Service's summons power and section 7602's legislative history (Brief for the United States at 16-21),[6] the Government argues that, under the "might throw light" standard, "[t]ax accrual workpapers contain evidence unquestionably relevant to the Internal Revenue Service's tax investigations." Brief for the United States at 21.

The Government makes much of the presence of the words "may be" in section 7602. It argues that because the tax accrual workpapers *may* include facts that *may* suggest that audit adjustments *may* be appropriate, *may* require the assessment of additional tax, *may* cast serious doubt on the propriety of the taxpayer's decision not to report a particular transaction or item, or *may* shed light on the taxpayer's state of mind, then the relevance requirement of the Code is satisfied, even though the factual information *may* in fact be readily available on an ordinary audit of the taxpayer's books. *See* Brief for the United States at 24-25. The Government continues that, although tax accrual workpapers contain the accountant's and taxpayer's opinions and judgments about the propriety of the taxpayer's reporting positions and the likelihood of the Service's challenging those positions, the summons is not issued primarily to gain access to those opinions and theories. Rather, the Government insists, the Service's chief interest is to discover all the relevant facts. The Government argues metaphorically that the summons is simply a device by which the Service

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[6] *But see* Note, *A Balancing Approach to the Discoverability of Accountants' Tax Liability Workpapers under Section 7602 of the Internal Revenue Code*, 60 Wash. U.L.Q. 185, 193 & n.76 (1982); Comment, United States v. El Paso Co.: *A Shift in Policy Towards IRS Summons of Tax Accrual Workpapers*, 36 Tax Law. 835, 840 & n.64 (1983) ("[i]t is not helpful to resort to the statute's legislative history to determine the congressional intent underlying the relevance requirement").

becomes aware of the needles in the haystack. Brief for the United States at 26.

That argument, however, proves too much. By issuing a summons for tax accrual workpapers, the Service seeks more than the location of needles in haystacks: it seeks to have the taxpayer and his accountant thread the needle and sew. To insist that the Service seeks "just the facts" is either to misapprehend the true nature of tax accrual workpapers or to display a high degree of disingenuousness.

This Court, of course, has never directly addressed the propriety under section 7602 of the "might throw light" standard of relevance. Several circuits, however, have expressed reservations about that standard and especially about the dangers of adopting too broad an interpretation of the term. For example, the Second Circuit in *United States v. Harrington*, 388 F.2d 520 (2d Cir. 1968), held that even under *Foster* (which that court decided before *Powell*) a summons will not be enforced unless there is "an indication of a realistic expectation rather than an idle hope that something may be discovered." *Id.* at 524; *accord United States v. Bisceglia*, *supra*, 420 U.S. at 150-51 (section 7602 does not authorize a "fishing expedition" by the Service); *United States v. Theodore*, 479 F.2d 749, 754 (4th Cir. 1973) (same). A similar concern was voiced by the Eighth Circuit in *United States v. Matras*, *supra*, where the Service issued a summons for the taxpayer's proposed budgets—"only a projection of what the actual transactions would be," 487 F.2d at 1272—on the ground that they would be useful as a "road map as to where we want to go." *Id.* at 1273. The Eighth Circuit refused to enforce the summons. In doing so, the court first explained that "[t]he term 'relevant' connotes and encompasses more than 'convenience.'" *Id.* at 1275. Then, it added:

> Consequently, we are not persuaded to fault the district judge for concluding that the government failed

> to sustain its burden of proof by alleging a general need for a "road map." If we were to accede to the government's view, it is difficult to imagine corporate materials that might not contribute to a more comprehensive understanding of the workings of the corporation, and thus, according to the government, be deemed relevant to the tax investigation.

Id.

The policy reasons for not adopting the Service's proposed definition of relevance were elaborated on by both the district court and the Tenth Circuit in *United States v. Coopers & Lybrand*, *supra*, which specifically involved tax accrual workpapers. In that case, the Tenth Circuit cited *Matras* with approval and then agreed with the trial court that tax accrual workpapers, like the proposed budgets in *Matras*, are not relevant for section 7602 purposes. The court of appeals reasoned, as follows:

> [E]xtending IRS contentions herein to their logical conclusion, it is hard to determine what corporate records would not fall under a § 7602 summonses [*sic*] if the standard endorsed the production of *any* records which *might* show tax fraud or tax liability. IRS does not, as it appears to assume on this appeal, have *carte blanche* discovery.

550 F.2d at 619 (emphasis in original), *aff'g* 413 F. Supp. 942, 948 (D. Colo. 1975) (several factors must be weighed in deciding whether tax accrual workpapers are relevant, including the adverse effect disclosure might have on the interchange between the taxpayer and its independent accountants and any resulting weakening of the securities laws).

Finally, in his dissent to the Fifth Circuit's decision in *United States v. El Paso Co.*, *supra*, Judge Garwood thoroughly and thoughtfully analyzed the relevance requirement of section 7602 in the context of a summons for tax accrual workpapers. Observing that the summons was issued not to determine any factual information but

rather "to discover the *post-return* 'private thoughts and theories of the taxpayer' and 'the thinking of [its] accounting analysts and policy makers about tax decisions,'" Judge Garwood stated:

> [T]he IRS does not seek these theories and opinions of the taxpayer concerning its prior taxes because they may be relevant to the *actual* correctness of El Paso's returns or the *actual* amount of tax owed. The Service asserts no such potential relevance here. Rather, as the majority candidly recognizes, the taxpayer's theories and opinions are sought merely because they may "focus and concentrate the Service's energy," "may be useful to the IRS as a 'road map' through a company's tax return," and will enhance "the efficiency" of the "IRS audit." Accordingly, here the bottom line is *not* figures or facts or even opinions; it is, rather, *the convenience of the Service.* That will not suffice.

682 F.2d at 546 (Garwood, J., dissenting) (emphasis in original) (citations and footnotes omitted).

Judge Garwood next turned to section 7602's requirement of potential relevance, noting that although the Code uses the words "may be" rather than the word "is," Congress did not intend "to attenuate or dilute the nexus that 'relevant' implies." *Id.* at 546 n.4 (Garwood, J., dissenting). He explained:

> The matter to which the examined books or data must be potentially relevant is "such inquiry." It appears that Congress used "inquiry" here in the sense of "question," to refer to the *subject matter* inquired about rather than the process or performance of investigation to elicit the correct answer to the question. Accordingly, "such inquiry" or "such question" is properly understood as referring to the question of "the correctness of any return" or "the liability of any person for any internal revenue tax."

Id. at 546-47 (Garwood, J., dissenting) (emphasis in original) (footnote omitted). Because tax accrual work-

papers cannot possibly have any bearing on the correctness of the return or the liability of any person for a tax, but rather could only facilitate or make more efficient the process of examination, they are not even potentially relevant within the meaning of section 7602. *Id.* at 547 (Garwood, J., dissenting).[7] *See also* Caplin, *Government Access to Independent Accountants' Tax Accrual Workpapers*, 1 Va. L. Rev. 57, 72-75 (1981); Note, *IRS Access to Tax Accrual Workpapers: Legal Considerations and Policy Concerns*, 51 Fordham L. Rev. 468, 477-79 (1982).

The Eighth Circuit in *Matras*, the Tenth Circuit in *Coopers & Lybrand*, and Judge Garwood in his well-reasoned dissent in *El Paso* properly concluded that application of too open-ended a definition of "relevance" would constitute an abdication of the courts' supervisory responsibility under section 7604 and would effectively eviscerate the protections Congress intended be afforded by that section. To keep the Service's summons power "within its proper bounds" (*United States v. Bisceglia*, 420 U.S. at 151), this Court should recognize the limited probative value of tax accrual workpapers and hold that the "realistic expectation rather than an idle hope" standard of *Harrington* is an integral part of section 7602.[8]

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[7] *See also id.* at 548 (Garwood, J., dissenting) ("throw light upon" means "throw *factual* light upon").

[8] The Court has already considered the Government's "convenience" argument in another context. In *United States v. Baggot*, 51 U.S.L.W. 5075 (U.S. June 30, 1983) (No. 81-1938), *aff'g* 662 F.2d 1232 (7th Cir. 1981), the Government sought disclosure of grand jury materials to the Service for use in connection with a civil tax audit, arguing before the court of appeals that although it had alternative means of obtaining the information, those means would "take longer." 662 F.2d at 1237. The Court rejected the Government's position, and although the decision in *Baggot* rests on the technical requirements of Rule 6(c)(3)(C)(i) of the Federal Rules of Criminal Procedure and on the public policies supporting grand jury secrecy, the decision demonstrates that the Government's claim of convenience must be scrutinized, especially where countervailing

Thus, the Court should find that, absent allegations of fraud or a showing of substantial need (such as the destruction of corporate records by fire), nonfactual materials (such as tax accrual workpapers) are not even potentially relevant and hence are not subject to the Service's summons power.[9] Limiting the definition of relevance to factual materials (except perhaps in those cases involving allegations of fraud where the taxpayer's state of mind would be at issue) would not only be eminently sensible but would vivify the protections afforded by section 7604.

C. Substantial Countervailing National Policies Require that, Absent Allegations of Fraud or a Showing of Substantial Need, the Work-Product Doctrine Be Applied to Protect Tax Accrual Workpapers from Compelled Disclosure.

Although concluding that tax accrual workpapers are potentially relevant under section 7602, the court below properly held that the policies underlying the federal securities laws require that, absent allegations of fraud, a

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national policies are involved. *See also United States v. Sells Engineering, Inc.*, 51 U.S.L.W. 5059, 5066 (U.S. June 30, 1983) (No. 81-1032) ("if we were to agree with the Government that disclosure is permissible if the grand jury materials are 'relevant to the matters within the duties of the attorneys for the government,' * * * [a] court order would be a virtual rubber stamp for the Government's assertion that it desires disclosure").

[9] *Cf. P.T. & L. Construction Co. v. Commissioner*, 63 T.C. 404, 414 (1973), in which the Tax Court explained: "What is relevant [under the Tax Court's discovery rules] is the *factual information* which may either reveal evidence that will be admissible at the trial or lead to the discovery of such evidence. Mental impressions, legal analysis, conclusions, and recommendations are generally not relevant." (Emphasis in original.) *See also* Fed. R. Evid. 401; Comment, *supra* p. 14, at 842-43 n.84 (under Fed. R. Evid. 401, tax accrual workpapers "would appear not relevant, since [they do] not make the existence of the fact in issue, i.e., the actual correctness of the return, more or less probable, but only easier to determine").

summons for tax accrual workpapers not be enforced. Consequently, the Second Circuit fashioned a work-product privilege that shields such workpapers from routine disclosure, thereby preserving the integrity of the financial accounting process. 677 F.2d at 221, *citing Hickman v. Taylor*, 329 U.S. at 512-13. The decision of the court below should be affirmed not only because the court struck the proper balance between the Service's interest in collecting revenues in a convenient manner and the strong national interest in maintaining fair and honest securities markets, but because any other result would undermine the fairness of the self assessment tax system.

The Government acknowledges that "contrary legislative purposes" and "countervailing policies" can undercut the broad latitude provided to the Service under section 7602. *See United States v. Euge*, 444 U.S. at 711, 715-16. Nevertheless, the Government contends that the Second Circuit's reliance on this Court's decisions in *Hickman v. Taylor* and *Upjohn Co. v. United States*, 449 U.S. 383 (1981), is misplaced and that the rationale and policy grounds for fashioning even a qualified privilege (to foster candid communications, in this case, between a company and its independent auditors) are not applicable to tax accrual workpapers.

The Government, however, protests too much. Indeed, its own client—the Internal Revenue Service—has publicly recognized the adverse effects that routine disclosure of tax accrual workpapers may cause. Specifically, in May 1981, Commissioner of Internal Revenue Roscoe L. Egger, Jr., stated that a Service policy of routinely seeking tax accrual workpapers "had real potential for serious negative effects on the quality of financial reporting." Internal Revenue News Release, IR-81-49, Remarks by Roscoe L. Egger, Jr., Commissioner of Internal Revenue, Before the Joint Meeting of the San Francisco Chapter of the California CPA Society and the Tax Section, San Francisco Bar Association, San Francisco, California,

May 5, 1981 (*reprinted at* [1981] 10 Stand. Fed. Tax Rep. ¶ 6598).[10] Similarly, the Justice Department's Advisory Committee on Tax Litigation has concluded that there are "strong policy reasons" for not examining tax accrual workpapers and has accordingly recommended that tax accrual workpapers be sought only where—

> there is a reasonable belief that the workpapers would disclose *facts* or circumstances relating to a *particular transaction* or transactions where such *facts* or circumstances *are not otherwise available or apparent through the normal audit procedure.*

Report of Justice Department Advisory Committee on Tax Litigation, *Standards for Seeking Accountant's Tax Accrual Workpapers* (May 1980) (emphasis added), *quoted in* Stoltenberg & Robinson, *Enforcement of Summonses in Requesting Accountants' Workpapers*, 60 Taxes 673, 677 (Sept. 1982).

Finally, the commentators who have addressed the tax accrual workpapers controversy have almost without exception concluded that the Service's policy with respect to tax accrual workpapers has already had or could well have an adverse effect on the quality of financial reporting. *See, e.g.*, Caplin, *supra* p. 18, at 81-82 (policy arguments for limiting access to tax accrual workpapers

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[10] Commissioner Egger's remarks were followed by a revision of the Service's rules for requesting tax accrual workpapers. Under the amended rules (which are found in section 4024.4 of the Internal Revenue Manual), an examiner is not to request tax accrual workpapers until (1) the tax examination is substantially completed, (2) specific issues are identified, and (3) the taxpayer (and his accountant) are requested to provide all known *facts* that relate to the identified issues. *Guidelines for Requesting Audit or Tax Accrual Workpapers*, I Internal Revenue Manual—Audit (CCH) § 4024.4 (May 14, 1981). Given the Service's recognition of the need to preserve the high quality of financial reporting and its own apparent doubts about the propriety of routinely seeking tax accrual workpapers, the Court should hold that, under a proper reading of the good faith requirement of *Powell*, compliance with the revised procedures is *required* under section 7602.

are persuasive); Hanson & Brown, *CPAs' Workpapers: The IRS Zeros In*, 152 J. Acct. 68 (July 1981) ("IRS activity already has caused a rapid deterioration of the accountant-client dialogue"); Note, *A Balancing Approach*, *supra* p. 14, at 206-07 (analogy to work-product doctrine is strong; if tax accrual workpapers are available to the Service, "the accountant will perform the required work in his head and less accurate reporting of financial position will result"); Note, *IRS Access*, *supra* p. 18, at 484 (considerable evidence indicates "that the free flow of information concerning tax contingencies will be impaired despite the independent reasons that would seemingly prompt a corporation to remain candid"); Comment, *supra* p. 14, at 835 (enforcement of summons "is against sound public policy because it discourages disclosure of financial information to independent auditors and thereby undermines the integrity of the financial reporting process").[11]

Thus, the Government's arguments notwithstanding, unless the court below is affirmed, the quality of financial reporting—and hence the policies underlying the federal securities laws—could be seriously impaired. The Government argues, of course, that application of the work-product doctrine is not justified here because the accountant owes its loyalty not to its corporate client but rather to the public. Brief for the United States at 29-33. That

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[11] *See also* Diss & Hanson, *Tax Contingency Audit Workpapers: 1981-1982 Developments, Observations and Proposals*, 14 Tax Adviser 154, 162 (Mar. 1983) (if summonses are routinely enforced, "[c]orporations and auditors may be tempted to resort to the 'unwritten' expedient, the very result that the Supreme Court wished to prevent when it first announced the work-product doctrine in *Hickman v. Taylor*"); Fishman, *Intentional Destruction of Tax Workpapers: An Analysis of a Relatively Uncharted Area*, 58 J. Tax. 214 (Apr. 1983) (discussing non-retention of workpapers as alternative to turning them over to the Service); Note, *Protecting the Auditor's Work Product from the IRS*, 1982 Duke L.J. 604, 616 (auditors could "change documentation procedures to ensure that the IRS could gain little from reviewing CPA audit workpapers").

argument, however, misses the point. Absent application of the doctrine here, the accountant will be unable to effectively serve as an instrument of public oversight. The accountant assuredly must remain independent, but he must also rely on the corporation to provide him with information necessary to fulfill his obligation; because he cannot know that he is missing information unless he knows that information exists, the possibility of the accountant's qualifying his opinion (unless the company is completely candid) can hardly be said to wholly supplant the need for application of the work-product doctrine. *See* Note, *Protecting the Auditor's Work Product*, *supra* p. 22, at 610.

It was concern about the policies underlying the securities laws that led to the Court's decision in *Upjohn Co. v. United States*, *supra*. In that case, the Government argued that no privilege was necessary because there were independent reasons for the corporation to seek legal advice. The Court found, however, that, even assuming an investigation to ensure compliance were undertaken, "the depth and quality of any investigations to ensure compliance with the law would suffer" unless the privilege was extended to those individuals in the corportion who had knowledge of the relevant information. 449 U.S. at 392-93 & n.2. The Government's argument here resembles closely the one it made in *Upjohn* and, as the court below noted, 677 F.2d at 220 & n.9, the Court's holding is equally applicable here.

The Government also argues that the Court's decision in *Couch v. United States*, *supra*, supports fully its position here. In *Couch* the Court did reject the taxpayer's claim of accountant-client privilege, but that case involved allegations of fraud and possible criminal violations.[12] In

[12] The Government also cites *United States v. Nixon*, 418 U.S. 683 (1974), and several other privilege cases decided by the Court to bolster its argument. Brief for the United States at 15. With the exception of *Herbert v. Lando*, 441 U.S. 153 (1979), however,

addition, the summoned materials in *Couch* were used by the taxpayer's accountant in preparing her tax return and had no bearing at all on the federal securities laws. Moreover, *Couch* was decided before Congress enacted Rule 501 of the Federal Rules of Evidence which authorized the courts, using "the light of reason and experience," to recognize new privileges.[13] *See* Note, *Protecting the Auditor's Work Product*, *supra* p. 22, at 622, *citing Trammel v. United States*, 445 U.S. 40, 47 (1980) (Congress's intention was "not to freeze the law of privilege").

In the instant case, in contrast, there have been no allegations of fraud or any showing of substantial need. The workpapers, moreover, were not used in preparing the taxpayer's returns. Perhaps most important, the documents here at issue were prepared to ensure compliance with the federal securities laws, and thus affirming the court below would not require recognition of a broad accountant-client privilege which was the issue in *Couch*,

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the cases cited by the Government involved grand jury proceedings and the administration of the criminal justice system, which necessarily involved constitutional considerations. That clearly is not the case here. *Herbert v. Lando*, involving a civil suit for libel, is similarly inapposite, for in that case the defendant's state of mind was a "critical element" of the plaintiff's cause of action.

[13] Indeed, *Couch* was decided shortly after the Court promulgated rules of evidence that specifically enumerated several narrow privileges not including an accountant-client privilege. 56 F.R.D. 183, 230 (1972). The Federal Rules of Evidence were promulgated by the Court on November 20 and December 18, 1972, to become effective in July 1, 1973. *Couch* was decided on January 9, 1973. Three months later Congress passed a law providing that the privilege rules would not go into effect until Congress specifically provided. Act of Mar. 30, 1973, Pub. L. No. 93-12, 87 Stat. 9. As approved by Congress (Act of Jan. 2, 1975, Pub. L. No. 93-595, 88 Stat. 1926, 1933-34), the federal rules do not enumerate specific privileges, but rather provide (in Rule 501) that the law of privilege is to be governed "by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience."

but rather the application of the work-product doctrine to a narrow set of documents.

Amicus Tax Executives Institute respectfully submits that, in the absence of allegations of fraud or a showing of substantial need, the strong public interest in maintaining the high level of financial reporting far outweighs the Service's purported "need"—for convenience' sake—for a "road map." In addition, by holding that a summons for tax accrual workpapers will ordinarily not be enforced, the Court will preserve the integrity of the self assessment tax system, which depends on taxpayer perceptions of fair play and evenhandedness. As former Commissioner of Internal Revenue Mortimer Caplin has observed:

> An additional concern is the adverse impact of the tax accrual controversy on the nation's self-assessment system. The federal income tax system is based upon cooperation by the public through voluntary compliance and self-assessment of taxes. To preserve this process, the Service must treat taxpayers in a fair, evenhanded manner, and demonstrate to the public that it is doing so.

Caplin, *supra* p. 18, at 82; *accord United States v. Arthur Young & Co.*, 677 F.2d at 217, 220.[14] Consequently, the Court should hold that the public policies underlying the federal securities laws and the self assess-

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[14] *See also* Note, *A Balancing Approach*, *supra* p. 14, at 207 (the self assessment system is "grounded in an assumption of fair play by both sides"; "[a] requirement that the taxpayer, in effect, prepare the IRS's case against his position is beyond the bounds of fair play and is thus disruptive to the self assessment system"); Note, *IRS Access*, *supra* p. 18, at 471 ("workpapers may reveal the willingness of the taxpayer to settle or litigate various positions taken on the return, giving the Service a distinct advantage in the resolution of issues raised during an audit"); Comment, *supra* p. 14, at 849-50 (with access to tax accrual workpapers, including "corporate rationale not to litigate based on reasons unrelated to tax liability," the Service could exact concessions even where its own position was weak).

ment system require that a summons for tax accrual workpapers ordinarily not be enforced.

D. Section 6661 of the Internal Revenue Code Circumscribes the Internal Revenue Service's Authority to Obtain Tax Accrual Workpapers under Section 7602 and Manifests Congress's Intent that the Disclosure of Such Workpapers Not Be Compelled.

Finally, the Government argues that the court below erroneously concluded that a conflict exists between the Service's summons authority and the national policies underlying the securities laws. It cites the Court's decision in *St. Regis Paper Co. v. United States*, 368 U.S. 208 (1961), for the proposition that a "clear statement of congressional purpose is required to create a special rule preventing the disclosure of relevant information to a duly authorized government agency." Brief for the United States at 43. Arguing that no special rule exists with respect to tax accrual workpapers, the Government asserts that reversal of the case below follows *a fortiori* from the decision in *St. Regis*.

What actually followed *St. Regis* (which involved the disclosure of census data to the Federal Trade Commission), however, was an act of Congress overruling the Court's decision. Act of Oct. 15, 1962, Pub. L. No. 87-813, 76 Stat. 922. Although Congress's decision to limit the dissemination of census data (in response to an invitation by the Court to clarify the intent of the Census Act) does not by itself undercut the Court's holding in *St. Regis*, it provides strong support for the Second Circuit's position that, in determining whether a summons for tax accrual workpapers should be routinely enforced, proper weight should be accorded the strong policies underlying the federal securities laws that led to the preparation of the workpapers.

Moreover, whereas the Government insists that if a conflict exists, it is for Congress to resolve, it is respectfully submitted that Congress has already spoken. In-

deed, shortly after the court below rendered its decision in this case, Congress enacted legislation that at a minimum circumscribes and arguably vitiates entirely the Service's authority to seek tax accrual workpapers under section 7602 of the Code. Section 323(a) of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324, 613 (codified at section 6661 of the Code, 26 U.S.C. § 6661), provides a penalty for the substantial understatement of tax liability. That penalty is not to be imposed, however, to the extent the understatement is attributable to items with respect to which the relevant facts are adequately disclosed on the taxpayer's return.[15] Thus, Congress has passed legislation that requires, in order to avoid a penalty, the disclosure of relevant facts relating to positions for which the taxpayer does not have substantial authority.[16]

Although there is no direct statutory link between new section 6661 and the Service's authority to issue summonses under section 7602, the new provision is highly relevant to the Service's efforts to secure tax accrual workpapers. Indeed, the Second Circuit below referred specifically to such a provision (then in its nascent stages), as follows:

> In reaching this conclusion [not to enforce the summons], we are comforted by the knowledge that if Congress feels that this privilege unduly restricts the IRS's authority, it can require that this material be made available, or that taxpayers flag their questionable positions directly on their returns, in line with the suggestions of former Commissioner

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[15] I.R.C. § 6661(b)(2)(B)(ii). The penalty is also to be abated if the taxpayer has "substantial authority" for its position. I.R.C. § 6661(b)(2)(B)(i). Different rules apply in respect of tax shelters. I.R.C. § 6661(b)(2)(C).

[16] The Government refers to the enactment of section 6661 in its brief but does not discuss its significance to the outcome. Brief for the United States at 25 n.13.

> Kurtz, 32 Tax Law. [13,] at 15-16 [1978]; Cooper, The Avoidance Dynamic: A Tale of Tax Planning, Tax Ethics, and Tax Reform, 80 Colum. L. Rev. 1553, 1612 (1980). Procuring tax accrual workpapers under § 7602 seems to us to effectuate Commissioner Kurtz's proposals through the back door.

677 F.2d at 221.

Almost as if in response to the Second Circuit's invitation, Congress enacted section 6661. Significantly, the report of the Senate Committee on Finance confirms the connection between the new provision and section 7602 providing, as follows:

> [Section 6661] provides broad regulatory authority to permit the Secretary to prescribe the form of disclosure. However, *the committee intends that the Secretary shall in no event require the disclosure of accountant's work papers.*

S. Rep. No. 97-494, 97th Cong., 2d Sess. 274 (1982) (emphasis added). Thus, as was the case following *St. Regis*, Congress last year seemingly responded to a judicial invitation to clarify whether certain materials should be shielded from disclosure to government agencies, and it concluded in section 6661 that accountants' workpapers should not be disclosed.

Section 6661 affords taxpayers a choice of two means by which the substantial understatement penalty can be avoided—either by having substantial authority for the positions taken on the return or by disclosing the relevant facts in respect of those positions. If the Government's position here were to be sustained, taxpayers would be presented with nothing more than a Hobson's choice under section 6661, for disclosure would occur in all events—either on the return (pursuant to new section 6661) or during the audit (in response to a summons). That result, it is submitted, would be fundamentally at odds with Congress's intent in enacting section 6661.

Stated differently, section 6661 carefully prescribes what the taxpayer should disclose (essentially, the relevant facts relating to positions for which there is not substantial authority) and the consequences of not doing so (the understatement penalty). It defines, quite simply, the type of limited "road map" taxpayers must provide to the Service. To borrow the Second Circuit's analogy, having been told what information it can obtain through the "front door" (the tax return and supporting factual information), the Service should properly now be precluded from obtaining additional information through the "back door" (the summons).

CONCLUSION

For the foregoing reasons, the Court should affirm the decision of the court below.

Respectfully submitted,

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No. 82-687-CFX
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v.
Arthur Young & Company, et al.

Court: United States Court of Appeals
for the Second Circuit

Counsel for petitioner: Solicitor General

Counsel for respondent: Liggio, Carl D., Jackson, William Eldred

Entry	Date	Note	Proceedings and Orders
1	Sep 8 1982		Application for extension of time to file petition and order granting same until October 20, 1982 (Marshall, September 13, 1982).
2	Oct 20 1982	G	Petition for writ of certiorari filed.
3	Nov 22 1982		Brief of respondent Amerada Hess Corp. in opposition filed.
4	Jan 19 1983		DISTRIBUTED. February 18, 1983
6	Feb 22 1983		Petition GRANTED.
			**********
7	Mar 17 1983		Record filed.
8	Mar 17 1983		Certified original record & C.A. proceedings received.
9	Mar 21 1983		Record filed.
11	Apr 1 1983		Order extending time to file response to petition until May 7, 1983.
12	Apr 15 1983		Joint appendix filed.
13	May 4 1983		Order further extending time to file response to petition until June 6, 1983.
14	Jun 6 1983		Brief of petitioner filed.
17	Jun 27 1983		Order extending time to file response to petition until September 9, 1983.
19	Sep 9 1983		Brief of respondent Arthur Young & Company filed.
20	Sep 9 1983		Brief amicus curiae of El Paso Company filed.
21	Sep 9 1983		Brief amicus curiae of Chamber of Commerce of the US filed.
22	Sep 9 1983		Brief amicus curiae of Committee on Corporate Law etc. filed.
23	Aug 26 1983		Brief amicus curiae of Tax Executives Institute, Inc. filed.
24	Sep 12 1983		Brief amicus curiae of Amer. Inst. of CPA's filed.
25	Sep 9 1983		Brief of respondent Amerada Hess Corp. filed.
26	Sep 9 1983		Brief amicus curiae of Arthur Andersen & Co., et al. filed.
27	Sep 21 1983	D	Motion of Arthur Andersen & Co., et al. for leave to participate in oral argument as amici curiae, for divided argument and for additional time for oral argument filed.
28	Sep 23 1983	G	Motion of respondents for divided argument filed.
29	Oct 11 1983		Motion of Arthur Andersen & Co., et al. for leave to participate DENIED.
30	Oct 11 1983		Motion of respondents for divided argument GRANTED.
31	Oct 14 1983		CIRCULATED.
32	Nov 23 1983		SET FOR ARGUMENT. Monday, January 16, 1984. (2nd case)
33	Jan 6 1984	X	Reply brief of petitioner United States filed.
34	Jan 16 1984		ARGUED.